2007 YEAR END REVIEW OF MARKETS: THE GREAT CREDIT CRISIS

"A pathetic side of the manipulation of credit in modern times is that the owners of capital, especially little capitalists, are swept into a pool of adventure in which the actual lending of capital is on a great scale and performed by central agencies alleged to be so expert in debt trading that it is better to entrust all to them. In this way loans are made and debtors accommodated, representing risks that the owner of the money, were he lending directly, would never dream of taking. It is supposed that the great professional lenders are vastly experienced, and possess almost magical discretion. The truth is that these pompous egotists throw around money, in prosperous times, with as much abandon as though it were confetti." Freeman Tilden, A World In Debt, 1935

Markets in 2007

2007 produced modest gains for equity investors, while bond markets benefited from a second half surge in prices:

	2007	Last 3 Years	Last 5 Years	Last 10 Years
S&P 500	5.50%	28.13%	82.83%	77.53%
Value Line Composite	-3.82%	8.86%	66.79%	-3.10%
EAFE*	11.63%	61.46%	171.20%	137.55%
Citigroup 5 Year T-Note	10.24%	13.06%	18.33%	70.78%
Lehman Five Year Muni	5.14%	9.67%	17.29%	56.30%
Citigroup 3 Month T-Bill	4.74%	13.01%	15.64%	42.74%
CPI	4.15%	10.45%	16.18%	30.31%

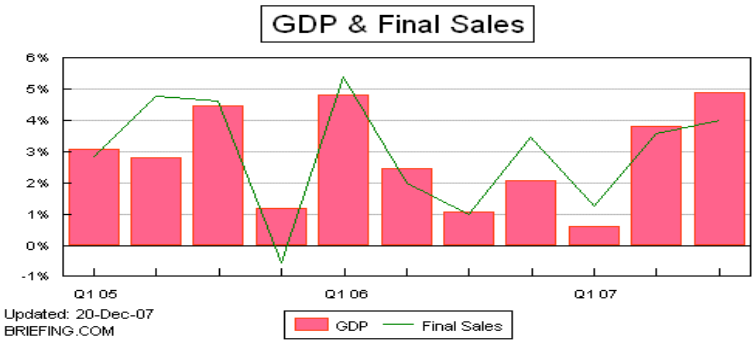
* EAFE is the Europe, Asia, Far East Index published by Morgan Stanley Capital International and is the leading benchmark for global equity returns

Growth stocks generally outperformed value stocks, and foreign markets again bested domestic indices as the U.S. dollar continued its downward spiral. Emerging and less developed markets topped the performance tables while hard assets, especially gold (up 31%), and precious metals, far outperformed OECD (Organization for Economic Cooperation & Development) market returns.

The great credit crisis which began in the summer of 2007 is not a short term phenomenon, but rather the beginning of a protracted period of adjustment in which great imbalances which have been built up in the global financial system will be diffused and corrected. The challenge for both U.S. investors and policymakers will be to navigate the highly deflationary tendencies of credit collapses during a time when the underlying domestic currency is, in itself, being re-priced downwards, which normally would lead to inflation.

Macroeconomic Outlook

U.S. GDP growth slowed meaningfully in the first half of 2007, but was ramping up nicely until the credit crisis struck in August:

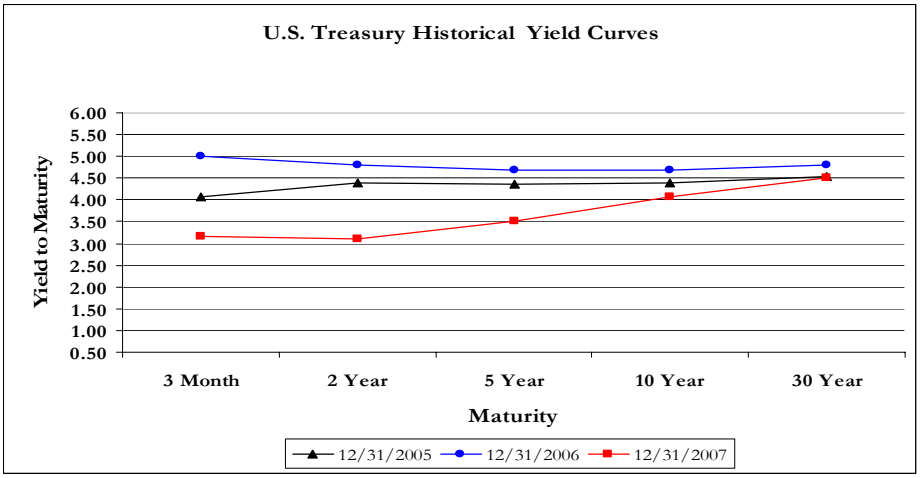


Talk of recession is in the air, which is defined as a "significant decline in economic activity" by the NBER, usually accompanied by at least two consecutive quarters of negative real GDP growth. S&P now estimates real 2008 GDP growth at just 1.9%. Others are following suit in lowering their estimates.

Inflation continues its broad global surge. Data recently released by the OECD shows the annual inflation rate in its 30 member countries rose to 3.3% in November from 2.8% in October, having been as low as 1.8% as recently as August. U.S. CPI finished the year at a 4.3% year over year gain, after reaching a fourteen year high of 4.7% in September.

Bonds

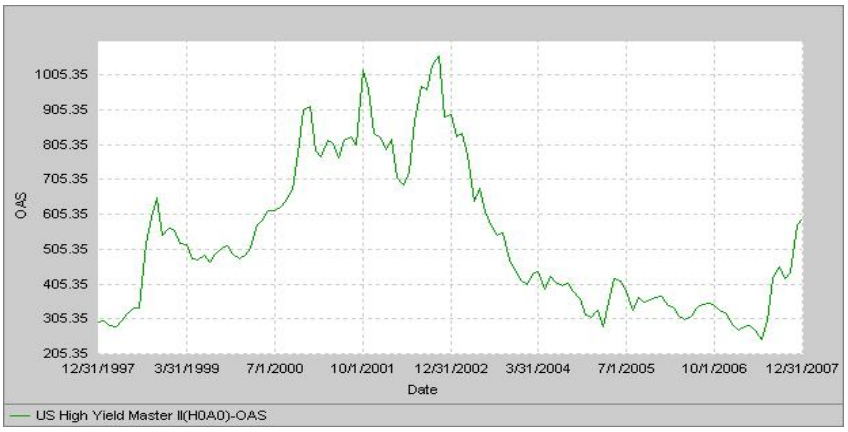
Yields gyrated wildly throughout 2007, as fears of inflation in the first half of 2007 gave way to dismay over economic prospects as the year closed. The Two Year Treasury Note began the year at 4.80%, rose to 5.12%, then plunged rapidly to 2.94% on December 12, the year's low. The shift in the yield curves below shows how quickly the market has responded to the Fed's interest rate cuts:



Investors should proceed in 2008 with the assumption that the Fed will continue to drive rates as low as needed to restore profitability to the battered financial sector, i.e. the banks. That is what it is all about at this point, and fighting inflation is an afterthought. The piper will be paid later.

We think investors should steer a wide berth around low quality paper in 2008. We know that there is huge volume of virtually unmarketable junk bonds sitting with the banks, and we also know that default rates finished 2007 at a 26-year low of 0.9%. We are at precisely the point in the cycle where prices have significant downside risk, as spreads widen and defaults rise. Moodys confirmed this when they recently opined that "the global default rate on high-yield, high-risk bonds will jump more than fivefold by the end of 2008. The high-yield default rate will increase to 4.8% this year and reach 5%

in 2009 because a weakening economy and ratings cuts will cause more issuers to miss their interest payments". Spreads, or the additional yield over Treasuries received by high yield bond investors, have recently begun ticking up, and they have much further to go should the recession scenario become reality:



Source: Merrill Lynch

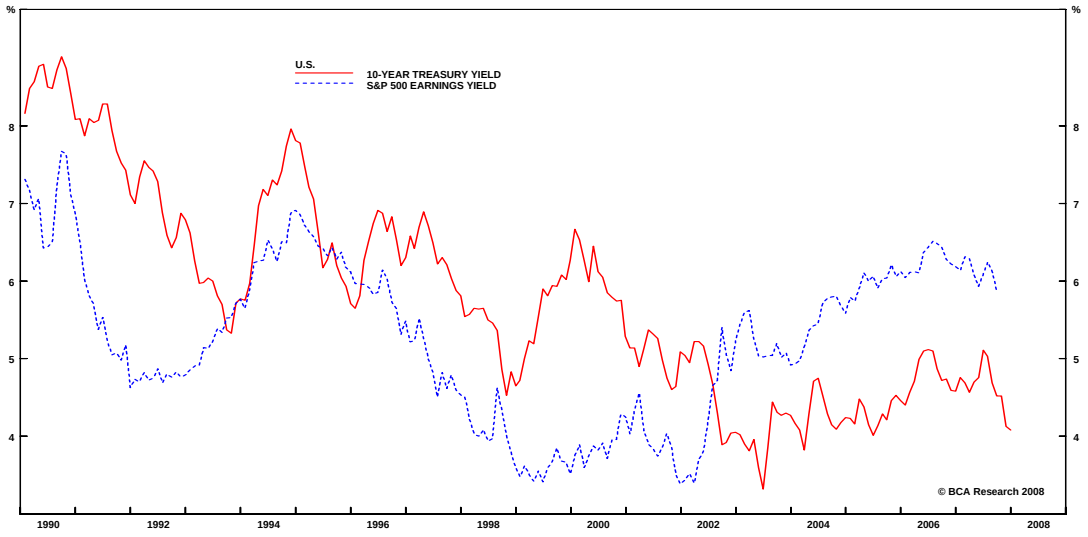
Stocks

Broad stock indices produced below average returns in 2007, as the financial and consumer discretionary sectors in particular were hammered. We have cautioned and continue to caution investors that broad-based indices like the S&P 500 will produce less than historical average returns based on where we are in the economic and demographic cycle. We believe successful investing requires distinct differentiation from an "index-hugging" strategy. Our managed equity portfolios produced returns around 20% in 2007 by overweighting the energy and materials sectors, and underweighting consumer discretionary and financial stocks. The sector returns for 2007 shown below should provide some evidence as to why getting "the big picture" right is so important in equity investing:

Energy	32.38%
Basic Materials	19.98%
Utilities	15.81%
Technology	15.54%
Consumer Staples	11.60%
Industrials	9.83%
Telecom	8.45%
S&P 500	***5.50%***
Health Care	5.39%
Consumer Discretionary	-14.32%
Financials	-20.84%

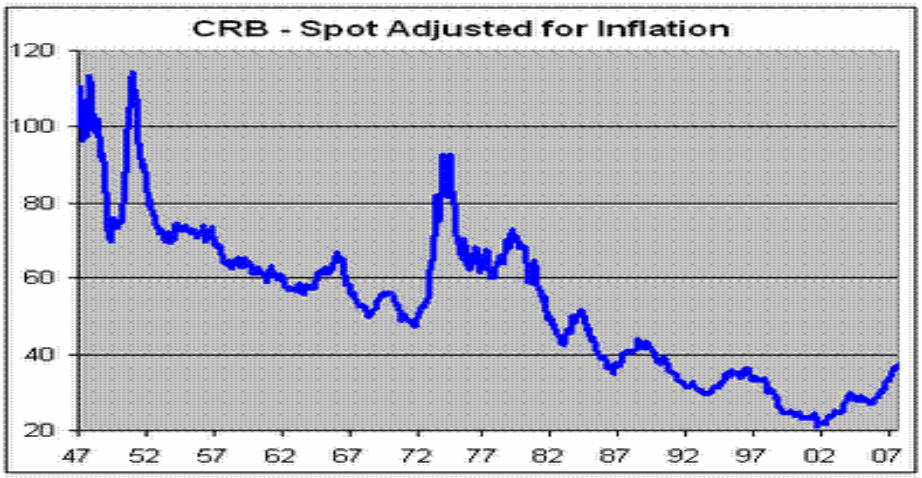
While a steep drop in late February and early March was short-lived, the real damage came in late summer and early fall as the credit crisis unfolded. Investors are now confronted with the spectre of recession, and much fretting is about as earnings growth estimates are recalibrated downward. Expectations for fourth quarter are for a 9.8% DECLINE in earnings, following a 4.5% decline in the third quarter, which would mark the first back to back decline in quarterly earnings since late 2001 and early 2002. So we are not surprised to see stocks struggling of late. For all of 2007, earnings growth looks set to average 1.2%, down from 8% expected in October (much of this weakness comes from the financial sector). For 2008, though, estimates currently rest at 15.7%, a far too generous number in our view. We would be happy to see a normal earnings growth rate of 7%, about twice GDP.

But just because the U.S. is slowing does not mean that every company in every industry is going to choke. And, when comparing the 10 Year Treasury Yield vs. the Earnings Yield on stocks (S&P 500 earnings divided by S&P 500 price), the disparity is about as wide as it has ever been (meaning stocks generally offer superior return potential versus bonds---this is one of the Fed's favorite measures of valuation):



In the end, earnings drive and support stock prices and once the current earnings weakness abates, stocks will recover and go on to make new highs. But patience will be required as the first half of 2008 is going to see some mighty soggy numbers come in. In this environment, we emphasize again that investors should focus on industries and groups that will benefit from globalization and which possess strong earnings and macroeconomic fundamentals, especially in areas where scarcity/market dominance enables pricing power. It is also critical to be in the right sectors (back to our Canoe Theory, which states that a vessel floating downstream with the current has a far easier and more enjoyable ride than one paddling upstream against the current).

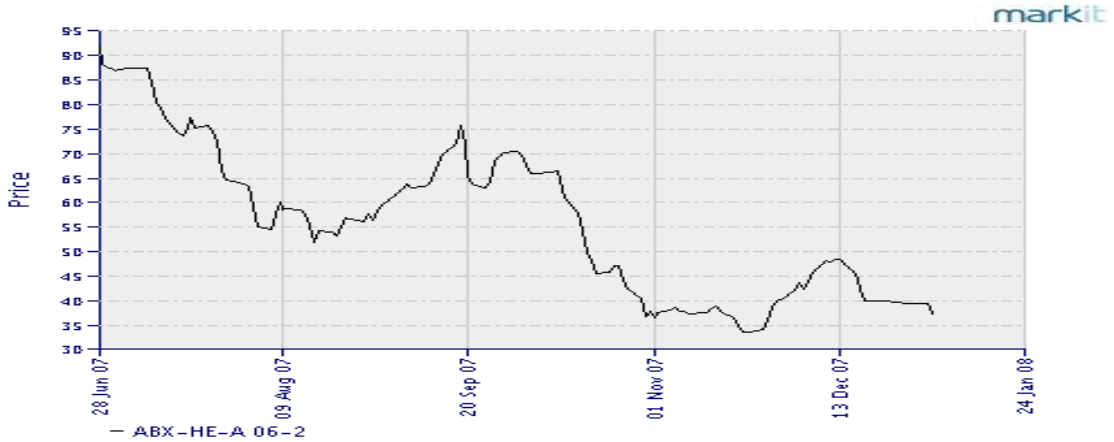
We also think most investors are missing the boat when it comes to "hard assets", or commodities. Because of the huge increase in prices of late, many investors think that commodities are ripe for a fall. Yet, when measuring the real prices of commodities back to 1947 using the CRB Index (the oldest and most respected broad commodity measure) we can see that prices are not even close to their potential after inflation is accounted for:



The Real Story of 2007

Last January, in our 2006 Year End Review, we wrote that the aggressive search for higher returns by market participants had "created a sense of carelessness and near utter disregard for risk as these managers buy on faith and hope, rather than sound fundamentals". We expected a downward adjustment in prices for risky assets, writing in our Mid-Year Review that "the main event for housing and the U.S. economy is now moving to center stage: a tidal wave of mortgage defaults and a collapse in the value of the bonds securitized by "sub-prime" loans."

That carelessness has now become painfully clear, as large and highly respected global banks, brokers, and fund managers are being forced to write down billions of dollars of dubious bonds they bought. What once masqueraded as "AAA-rated" paper became "toxic waste" nearly overnight, as the violent collapse in prices for the leading sub-prime mortgage index clearly shows:



Source: Markit Group Ltd.

These sub-prime loans are only one example of a system run amok in its disregard for risk. Structured Investment Vehicles (SIV's) also entered the investor vocabulary in 2007. These were off balance sheet leveraged funds created by regulated banks expressly for the purpose of goosing profits by avoiding the capital reserves required under international banking standards (the Basel Accords). (Any risky asset on a bank's balance sheet must have capital set aside to cushion against non-performance. That is capital that cannot be deployed to earn a higher return elsewhere.) The SIV's borrowed money for 30 to 90 days, and used the proceeds to buy assets of longer maturities, earning the "spread" or difference between the cost of funds and the earnings on the assets. It all worked great until the graph you see above began informing the short term SIV investors what their long term assets were looking like. When short term paper came due, the SIV's could'nt pay it back because no one was stepping up to buy the new debt. Thus Citigroup, HSBC and others had to take the SIV's back on their balance sheets and pay off the maturing short term notes, to the tune of tens of billions of dollars (this is what some have referred to as a "freezing" or "locking up" of the credit markets). Banks have so far written off some $70 billion of bad SIV's, and we think the total could be several times that by the time "market clearing prices" are reached.

And this is only the beginning. Banks are also the unlucky holders of some $230 billion of unmarketable high yield bonds they underwrote for leveraged buy-outs in 2007 (the "private equity" craze), and news came in late December that they marked down their inventory by up to 10% in an attempt to sell the bonds. So another $20 billion or so in shareholders equity will vanish. New issues being marketed are facing a paucity of

buyers, so the banks will be stuck with even more unmarketable debt on their balance sheets. High yield spreads have no where to go but up. Many of these loans were packaged and sold in the form of CLO's (collateralized loan obligations) by these same banks, and they are going to begin experiencing the same sort of stress as the underlying bonds.

Balance Sheets Eviscerated

And so all these risks that had supposedly been transferred to other investors are now flooding back onto banks' balance sheets, creating enormous losses, and the mission de jeur of those who chased these ephemeral profit propositions is to replenish the years and decades worth of Shareholders Equity/Retained Earnings that have vanished under their watch in just a few short months. These were the world's most respected and admired financial institutions, and THEY BLEW IT. Thus we have Citigroup selling 4.9% of the Company to the Abu Dhabi Investment Authority at a cost to the bank of 11% per annum; Morgan Stanly selling 10% of the Company to the China Investment Corp. on similar terms; Union Bank of Switzerland and Merrill Lynch selling parts of their companies to Temasek Holdings, the investment arm of the government of Singapore. It is our view that the massive write-downs still to come will devour these recent capital infusions, leaving the banks begging for more.

In sum, the credit debacle of the last few months has revealed a banking system supporting a much larger asset base than most investors thought. And the assets being forced back onto banks balance sheets are of dubious value, creating a rapid-fire de-leveraging that is likely to have significant ramifications for the future. Primary among them is a need for far greater amounts of capital going forward, so share repurchases, dividend increases and the like are going to be tabled for quite some time to come in favor of asset sales and fresh equity issuance. Aggressive lending is also going to be curtailed.

Likewise, all of these exotic mechanisms for funding loans have withered and died (the so-called "originate and distribute" model), so it is likely that banks will need to fund more of their future loans from their own balance sheet. And the cost of funding has itself gone up, whether for basic deposits or securities underwriting (i.e. net interest margins are contracting). Returns will thus become more muted.

Regulators too have been asleep at the switch, and there is a massive wave of new rules coming which will restrict banks' activities. And so investors should be under no illusions: the banking system is facing a prolonged downturn in both activity and profitability.

More importantly, and of more lasting effect, is that the reputation of capitalism has suffered enormous damage**,** particularly the American brand, replete with "securitization" and other financial innovations. The U.S. dollar has also suffered in a guilt by association tango, and you can bet it is going to be a long time before the foreign holders of dollars are going to take a call from Wall Street pitching the latest innovative security. Going forward, it is going to be all about the Euro, Yen, Renmimbi, etc.---anything but the Greenback. We expect the dollar to continue its historic decline, and for gold and other precious metals to benefit commensurately.

Central Banks To the Rescue?

The result of all this is that banks are in no position to lend, and hoarding cash has been the order of the day, as the roach motel continues to send out a vast supply of its hidden denizens. Central banks around the world are FLOODING the system with cash to replace the surfeit, when what is really needed is the intangible known as CONFIDENCE. On December 18, the European Central Bank alone pumped $502 billion -- 130% of Switzerland's GDP! -- into the money markets in one day alone. The only effect these liquidity operations will have is to increase the money supply, and thus sow the

seeds of future inflation. (This is literally creating money out of thin air, and it will devalue those dollars, euros, pound, etc. already outstanding).

We warned about the "Four Inflations" in our last Semi-Annual review, and investors should not forget that ALL of the world's central banks stood ready to RAISE interest rates before the credit crisis erupted. And so, while policy makers worldwide are lowering rates to help the banks recover (i.e. bail out their monied friends on Wall Street), inflation has risen to 30 year highs in the U.S. and Europe. U.S. CPI has now risen to 4.4% year over year, and the PPI is up 7.2%. Food inflation is off the charts and going to get worse. Our view is that the recent bond market rally will persist only until it is clear that the credit crisis has turned the corner. At that point, the market will focus on growth and inflation, and discover that stagflation is not a pleasant place to be. It may take some time to develop, but fixed rates bonds will suffer inordinately in this environment, just as they did in the 1970's.

The Sticky Wicket

But first the credit crisis must recede, and that is not happening. The fact is that it keeps spreading into other connected areas. Fannie Mae and Freddie Mac announced massive write-downs in November, while changing the guidelines for new originations and invocation of their "government guarantee". It is not hard to envision a further crisis developing when these important government sponsored enterprises encounter the coming tidal wave of souring conventional mortgages.

As a further knock-on effect, credit card and auto loan delinquencies are rising. We expect to see this become a "mainstream story" in 2008, as the major media reports on the struggles of the ordinary consumer (which become yet another lead weight for the banks).

The crisis has also spread to the monoline insurance companies, with innocuous sounding names like MBIA, AMBAC, and FGIC. These companies provide credit enhancement for a fee, thus allowing a single-A rated debt issuer to obtain a AAA-rating. The problem is that these companies broadened their business of insuring plain vanilla municipal bonds into the new frontier of "structured products", which all their computer models told them could be insured profitably. But when the call came to pay up, the monolines found that they had'nt really collected enough in premiums after all, so there were "capital adequacy issues" that needed to be addressed. In late December, a second tier monoline, ACA, was downgraded and its shares de-listed, exposing Merrill Lynch, CIBC, et al to further massive losses. And so another chapter of the credit crisis begins, as those who bought "insured" bonds find out that the strength of the issuer is what matters after all, not an "insurance wrapper". And, by statute, some investors cannot hold anything less than AAA-rated paper, so the selling of the newly downgraded paper will be yet another downleg in an already decimated credit/bond market.

And, of course, we have yet to discover the joys of Counter-Party defaults in the derivatives/swaps market. These are "off balance sheet" transactions in which banks are obligated to exchange cash flows given a certain set of market conditions. This is an enormous "shadow banking system", in many cases, these potential liabilities are up to 10 times the tangible equity of the banks themselves, giving a whole new meaning to the word "leverage" and "domino effect". In just one segment of the swaps market known as "CDS", or credit default swaps, the Bank for International Settlements estimates that there was $43 trillion outstanding at year end 2007, more than half the size of the entire global banking system! Given the track record so far of these geniuses, we are not encouraged that they can manage through any potential malfunctions. This could be tomorrow's Page One story, which we desperately hope never to read. If we do, the fear gripping the markets now will become a vast tsunami which has the potential to absolutely decimate asset values globally. This is the meltdown scenario that central banks around the world fear the most, for which no cogent response has yet been articulated or is perhaps possible.

The Real Estate Mess

Last year, we pointed out the excessive rise in home values, and warned that a decline should be expected. We are now of the view that this is not a "normal" correction but an epochal event which will "re-write the books" on real estate as an asset class. Home prices got so far out of equilibrium that the "mean reversion" process should require several more years of declining values and poor sentiment for anything housing or real estate related.

Just this week, Treasury Secretary Paulsen, speaking on CNBC, noted of the housing market that "there is no evidence it is bottoming…the evidence would be that it has further to run." KB Home, one of the largest US homebuilders, noted in recently reporting a $773 million quarterly loss, that "as we enter 2008, we see no signs that the housing market is stabilizing." The CEO of Fannie Mae said "(this is) the toughest housing correction of our lifetimes". And so, while new home sales continue to plummet and new starts stagnate, we will begin to witness a "pushing on a string" phenomena: lower interest rates will fail to stimulate demand as consumers reorient themselves to their lower net worths (and bankruptcies) from the cascading fall in prices nationwide. And, because the decline started from such ridiculously over-inflated levels and mortgage money for qualified borrowers is much harder to come by, it is going to take a lot longer for the U.S. housing market to stabilize, let alone recover, than most people think.

Confidence in real estate prices will be further damaged in 2008 as overbuilt and over-hyped foreign markets follow the retreat begun in the U.S. In the United Kingdom, sentiment has swing sharply negative in the past two months as UK home prices have fallen, leading one economist to proclaim that "we have entered a phase of systemic declines in prices." Another noted "how rapid the change in the pricing environment has been". Similar pressures are building in Spain and Austrailia. Expect to hear more sour news from these markets in 2008.

These further declines in residential property values will be a decided negative for the economy in 2008 and beyond, especially on local government spending. Real estate taxes form the bulk of most local government revenues, and their appraisals and assessments usually run 1 to 3 years "in arrears" according to each entities' "revaluation schedule". Property being re-appraised now reflects what happened in 2005, 2006 and 2007. When lower values start hitting the books in 2008, 2009, and 2010, there is very little leeway given local assessing authorities, i.e., they must revalue downward to reflect current market conditions. Thus state and local government real estate tax receipts will not reflect the real impact of the housing downturn until 2008, 2009, and 2010. There will be only three options: cut the budget, increase taxes, or both. None of these options support a strong and growing local economy.

And unfortunately, residential declines are just the beginning. Commercial properties will follow, as tenants become harder to find and rent increases founder. The national vacancy rate for office buildings rose for the first time in four years in January to 12.6%, reflecting the weak economy, and it is likely just the beginning of a strong headwind. We have long maintained that unless a commercial real estate investor could obtain a "cap rate" at twice the current Treasury Bond yield (or 9% today), then there was little margin of safety (the cap rate is essentially the rate of return offered by a property based on today's purchase price and the estimated cash flows from the property). We have watched with interest this past year as many talented and informed participants have been selling their properties and/or downsizing their portfolios at cap rates of 6% and below. (Highwoods Properties – HIW – close by in Raleigh NC has been a prime example of a shrewd seller. Sam Zell, perhaps the best real estate investor of all time, sold his Equity Office Properties last December at the market top.) For us, it goes without saying that watching the deals is much more informative than watching stock prices, and it is thus writ large that there is a significant adjustment still to occur in the commercial

sector of real estate. Expect to hear much more about problems in the CMBS (commercial mortgage-backed securities) market in 2008 as the collateral supporting these securities goes down in value.

The Solution

All of the proposed solutions to this mess will drag out the ultimate resolution until the one sure-fire cure is applied: those who made bad decisions must suffer the consequences so the system can be cleansed. This is how capitalism has always worked. We are beginning to see a more proper functioning of the system as news came this week that Bank of America (a strong player) is stepping up to buy Countrywide Funding (a weak player). But proposed government bailouts will simply postpone and make worse the day of reckoning when these massive distortions and imbalances must be rectified. As Freeman Tilden wrote in 1935: "The whole progress of the legislative attitude toward the debtor, from the Roman Republic to the present day, has been steadily, though with occasional backward lapses, toward making debt easier to incur, lightening the burden of carrying and softening the consequences of default."

Oil & Energy Markets

Oil (WTI Spot Price) rose last year from $56 on January 1 to $96 on Dec. 31. This massive move has all sorts of prognosticators ruminating on what this means for investors. Here is all you need to know: Demand is rising, and Supply is shrinking. Higher prices will define these markets for years to come.

In late December, the IEA (International Energy Agency) made a startling announcement: in their published studies (considered the world's most authoritative), they admitted that they had overestimated supply by as much as 60%! The IEA's chief economist said they had been putting "a lot of emphasis on oil demand, which is wrong", and that supply factors should be looked at more closely. This is precisely what we have been warning about for the past several years. Now, we are likely to see declines in estimates of oil reserves and in overall production rates, leading to talk that global oil supplies will peak much sooner than expected. Investors should focus almost exclusively on reserves in the ground and in reserve replacement rates when evaluating energy companies, as this will drive valuations going forward.

Drilling down, we believe the most important concept for investors to grasp in light of the IEA's admission is that most of the world's proven and probable reserves (77%) are held by state-owned energy companies like Saudi Aramco, OAO Gazprom (Russia), and Pretrobras (Brazil). This means that investors have limited ownership rights, and are subject to the whim and say so of the likes of Vladimir Putin and Hugo Chavez. Even the world's largest private companies (ExxonMobil et al) have had their property confiscated and contracts annulled. So, going forward, investors had better focus on owning reserves in politically secure areas, and that means primarily North America.

Surging revenues from energy are fueling what we believe will be seen as the beginning of an era of scarcity and "resource nationalism" as these state-owned behemoths increasingly dictate the terms of commerce. We are particularly concerned about the resurgence of Russia. It is difficult to grasp for most Americans, but the government leaders in Russia also own and are the Chairmen and CEO's of that countries largest industrial conglomerates (Rosneft, Gazprom, Norilsk, etc.) It would be the same as Dick Cheney serving as Vice President of the United States AND CEO of ExxonMobil AT THE SAME TIME. The problem with the Russian system is that the powers of government stamp out any competition. There are no competitors: Gazprom is the national gas champion, Rusal for aluminum etc. What is evolving in Russia today is the world's most ruthless, efficient example of monopolistic resource nationalism, more commonly known as a kleptocracy.

It is clear to us that Russia will build on its resource nationalism to threaten Western interests. To start, it is quietly developing a chokehold on energy supplies to Europe.

When Russia signed an agreement in December locking up supplies through the Caspian Pipeline, the world looked the other way and yawned. Not us. This is the most significant energy corridor in the world outside of the Middle East, and Russia will now control all product transport out of the "Choastan" region of the world (Kazakstan, Uzbekistan, etc.). Russia has already intermittently threatened to cut off gas supplies to its former states (Georgia, Ukraine, Belarus), and has raised prices unilaterally in abrogation of established contracts. Their latest act of belligerence occurred on December 31, as Gazprom "offered" to take control of Serbia's state-owned oil monopoly for less than half its book value in exchange for support and investment, pre-empting a government privatization scheme in which several Western European companies were to have bid competitively. We believe it is only a matter of time before Europe is threatened by these pugnacious anti-Western forces. Europe will lose this war by talking it to death and not firing a shot. In a perverse twist of history, it will be the "Eurosclerotics" shivering in the cold in Paris and Berlin, instead of the Nazis at the gates of Stalingrad.

Russia has also stridently opposed U.S. plans to implement a missile defense system in Eastern Europe. They have quietly been upgrading their own missile defense systems, led by the RS-24 rocket, which can carry a single warhead up to 6,000 kilometers, effectively providing a shield for the entire Russian land mass and points far beyond. Russia has also launched 18 "Glonass" global positioning satellites and, with the launch of another six satellites this year, Russia will have completed its own Global Positioning System (GPS), rivaling that of the United States. Russian defense leaders have left no doubt that if the U.S. proceeds with their plans in Eastern Europe, their response would be "asymmetric". The rhetoric is startling, and leads us to believe that, absent political change in Russia, another "Cold War" is coming.

Meanwhile, China is treading fearlessly where others dare not. The Chinese Premier has visited 32 African nations this past year, and new roads, hospitals, and schools are being built thanks to the largesse of Chinese energy giants (in addition to oil wells, mining sites etc.) Our nomination for headline of the year comes from the Financial Times of 11/21/07: "Chinese Group Wins Rights to Afghan Copper". In one of the world's most dreaded and dysfunctional countries, the Chinese have secured long term EXCLUSIVE rights to what may turn out to be the world's largest copper deposit. It will be by far the largest investment ever made in Afghanistan by a foreign entity.

The Chinese throughout history have shown their superior strategic planning ability and patience (if we exclude the wrong turn they made into communism), and it is clear that they are busy enhancing their long term energy and materials security by focusing on the African continent and other places shunned by the West. This is a strategic blunder of the first order and the West will come to see its error over the course of the next generation.

The Bigger Picture and Outlook

For investors, 2008 will require an enhanced "risk management" mindset. It is our view that the credit crisis will grow, or become mainstream, in 2008 as formerly credit-worthy consumers pull back. We expect credit card and auto loan charge-offs to grow, and more and more conventional mortgages to become delinquent/default. CLO & CMBS problems will multiply. This will put further pressure on bank balance sheets, and impair their loan growth even further. Not the stuff of a robust economy. We expect further pressure on financials, and believe that stocks overall will not begin a broad-based rebound until this important sector stabilizes and can demonstrate sustained relative strength.

2008 will also require a renewed emphasis on owning assets with true intrinsic value. As we have seen, the value of large "blue chip" banks has proven to be an illusion, resting on generous accounting assumptions and sketchy asset values. We reiterate that our long-held emphasis on owning Strategic Assets is one of the few sound investment

theses for these changing times, as companies and assets that address conditions of scarcity are where real value resides. Agriculture and food, base and precious metals, and energy are areas that should occupy a significant weighting in investors' portfolios.

Unfortunately, most major market indices and mutual funds have pitifully low weightings in these areas, as they do not make up a large part of the investible "market cap" of the stock market. However, with careful research into global companies and some exchange-traded funds, investors can fashion sensible portfolios.

We also view 2008 as an important test of U.S. tax policies going forward. If the more populist factions gain the ascendancy, and income tax rates and capital gains taxes rise, it will be in direct contravention to the supply side revolution being embraced worldwide. Tax rates are plummeting across both developed and developing nations. In Germany, long a high tax stalwart, the top corporate tax rate was recently lowered to 30%; in Spain the same has been proposed, and eleven countries behind the former Iron Curtain in Eastern sport flat tax rates of 25%, with none of the mind-numbing and capital consuming complexity of the U.S. tax code. Bulgaria now wins the crown as the low tax capital of Europe, with a 10% flat tax rate. Even the Middle East is joining in, with Kuwait announcing a reduction in corporate taxes for foreign companies from 55 to 15%! And the trend is not new; it started in 1980 as OECD countries have slashed their personal tax rates from 64% then to 40% on average today.

In fact, America now has among the highest tax rates in the developed world (it is even higher when counting the egregious "double taxation" of dividends). We believe this explains in part why the U.S. dollar has been so weak, and it will certainly not help the case for owning U.S. assets in general if this year's elections produce higher tax rates going forward. Investors should include a significant allocation to ownership of foreign stocks, where the shareholder has a fighting chance to keep more of what is earned. And as the OECD economies age, investors should be mindful that the strong and irreversible demographic change that is coming should compel one to gain exposure to emerging markets over time.

Lastly, 2008 will require investors to keep a sense of perspective. Volatility is back, but after a five year absence, the markets are simply returning to their normal state. Investing is a risky business, and price movements now reflect that. Sometimes these price movements are warranted, sometimes they simply reflect the pendulum swinging between greed and fear. The rewards will still be there for those who are diligent. But the most important thing investors must possess in 2008 is courage, and a rock solid belief in their convictions. We will not let the markets shake us out of the truly world class assets that we feel we own, nor should you.

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