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ValueWorks

quality assets. compelling valuations.

Volume 7,3 **Q4 2008**

2008 dealt investors extreme volatility and turmoil. The events and market reaction were extraordinary and dramatic. But they were neither magical nor mysterious. In this letter I make the case that: (1) the recent meltdown was caused by specific policy mistakes, (2) those mistakes are being corrected and (3) that current conditions may offer opportunities that are just as dramatic as the implosion that created them.

The carnage was clearly dramatic. Yes, the S&P 500 declined by 37% -- and over 50% from high to low. And that made the S&P one of the better performing global indecies. Europe saw similar declines, and emerging markets fared worse. Investment banks dropped like flies and AAA credit ratings came to be virtually meaningless. Municipal bonds dropped by as much as 30%, with the typical closed-end municipal bond fund losing almost a third, and plenty declining by 50%. Overall, US equities retreated to levels first touched in 1997. More than a lost decade -- that's pushing twelve years. The successful investment stories were few and far between. And the investment fantasies of consistent high returns and no volatility (whether with Mr. Madoff or highly leveraged fixed income hedge funds) became the ultimate investment nightmares. 2008. Wow.

But the fact that 2008 was dramatic doesn't mean it was mysterious or inexplicable. It was a financial melt-down caused by policy mistakes. It was not the inevitable result of the creation of the Federal Reserve System in 1913, or the community development act of 1974, or the beginning of the End of Days. Nor was it caused by "greed on Wall Street," a "misalignment of incentives," a "re-pricing of risk," or even the over-extension of credit and the deflation of the housing bubble. Rather, the mayhem was the result of a typical credit cycle that was miserably botched. And while it is a difficult environment to work through, these are the very conditions that create particularly dramatic opportunity and upside.

Credit and liquidity were tight in the system coming into 2008 because, globally, central banks made it tight. They did so to cool growth, temper high commodity prices and prevent inflation. They did so to temper the overly loose credit that had been extended to home buyers, to let the air out of the housing market, and to drain speculative leverage from the system. That was important. Gradually, as these effects took hold, the global economy weakened. Global housing prices retrenched and weaker banks and financial companies were bankrupted. Remember it was in 2007 that scores of "sub-prime" lenders were bankrupted when money became tight and home prices started to decline.

Top 10 holdings*:

1. Pfizer Inc
2. 3m Company
3. Constellation Energy Pfd
4. Schering-Plough Corp
5. Boeing Company
6. Questar Corp
7. Boston Scientific
8. Zimmer Holdings
9. McGraw Hill
10. Teco Energy

—as of 12/31/08—

*see notes on p4 for additional Information

By the beginning of 2008 central banks began to tentatively reverse course. The tightening cycle had gone far enough and so it naturally led to a cycle of easing. In my letter of this time last year I wrote that economists could ask whether or not a recession had begun in the fourth quarter of 2007; conditions at that point warranted lower interest rates—a policy that helps banks in many ways. Because banks were vulnerable as a result of extended higher rates, and because an extended period of high rates had already wrung speculative excess out of the system, providing easier credit and greater liquidity was the right policy .

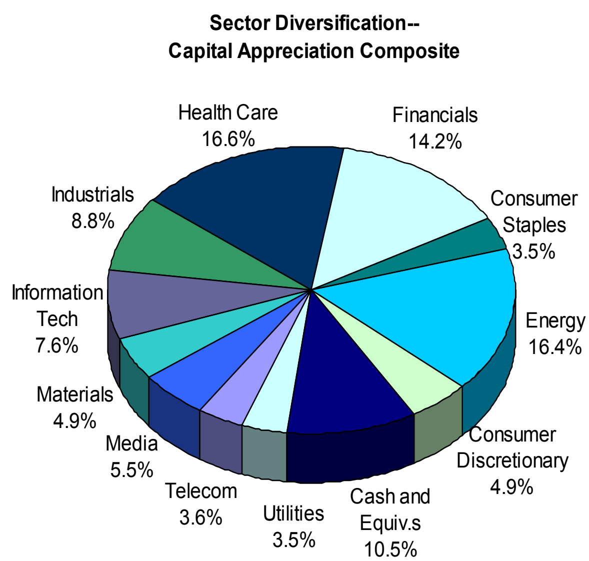
Central banks took several steps to increase liquidity from the period after the Bear Sterns collapse through the summer. But they also made several critical mistakes that served to undermine those efforts. One general mistake was the constant jawboning for financial companies to raise capital as a means of improving their credit quality. This undermined investor confidence in those companies. That's important because it had the concrete impact of dissuading investors from lending to the banks at historically normal spreads. By decreasing investor confidence, it made the banks inherently less profitable; by being less profitable, it became harder for them to improve their credit quality.

Nevertheless, the cycle was working for the most part normally until the Government again began to undermine confidence in the GSEs (Freddie Mac and Fannie Mae). Reports were leaked to The Wall Street Journal in August that the Government was considering taking them over. These reports undermined confidence. This set the stage for the Treasury Department's effective appropriation of the companies in early September.

That government takeover, quite predictably and reasonably, triggered a global run on financial institutions. This was compounded when that global run on financial institutions was not stopped at Lehman Brothers. When there is a run on the financial system, the central bank must act as a lender of last resort. If it fails to perform that role, the system goes through cataclysmic contractions. It is one thing to allow fringe players to fail in 2007 when the major players are all considered healthy. It is totally different to allow a major player to fail when it is not perceived as any weaker than the remaining players. By triggering a run on the financial system in early September, and then failing to contain that run early on, the costs of stopping the run and restoring liquidity became much, much higher. And the impact on the economy became much greater.

However, ultimately it becomes clear that more aggressive means are needed to restore confidence and create liquidity. That is the stage we are now in. As a result, we have the $700 billion TARP, government loans to the auto industry, and trillions of dollars pumped into the global financial system. We have interest rates approaching zero for banks and Treasury bonds. We have plummeting mortgage rates and energy prices. We likely have huge tax cuts and large government infrastructure programs in store. And it's not just the US: Europe is cutting rates aggressively and China is launching huge government spending programs to keep their economy going.

These massive efforts to create liquidity and restore confidence are just now beginning to have the effect of halting the run on the banks. The auto loans are stabilizing that industry, preventing further contagion. Low mortgage rates are triggering a refinancing boom. Lower energy prices are taking some of the pressure off middle-America.



These effects did not prevent an economic seizure in the fourth quarter. There was no credit, few cars or homes were bought, and jobs were cut. Both investors and consumers retreated. However, the first step in the process is to restore financial stability. Economic activity follows. Unequivocally, policy makers are employing powerful tools to restore confidence and create liquidity.

This is a painful, difficult, process. But it also serves some positive functions. All sorts of "excesses" build up during easy economic times. These include both shaky economic ventures as well as questionable investment strategies. These conditions put those activities to a harsh test. Less sound investment strategies are exposed. These run the gamut from complex, leveraged fixed-income hedge funds promising steady returns with little volatility (except for the really rare occurrence when they legitimately lose almost all their capital), to pure scams that dominate headlines for months.

As the enclosed reports show, our portfolios are not immune to this melt-down. Our investment strategy is not mysterious or magical. We focus on buying what we perceive as good quality assets at attractive prices. In periods of massive melt-down, they go down in price. And some of our individual purchases turn out to be less well-positioned than we thought. But, for the most part, the investments and underlying businesses remain intact. And once the crisis has run its course, those companies and investments tend to be even better positioned, offering much more dramatic upside than they offered prior to the crisis.

As we have in previous periods, we have used this turmoil to better position the portfolio. We sold securities during the last market upswing – before the market headed down. As securities have gotten cheaper, we've bought more. Our cash holdings are generally much lower than they were 15 months ago as the market was peaking. And our purchases have spanned the range from: Zimmer Holdings, a high quality, unleveraged maker of replacement hips and knees, to Teco Energy, a high yielding electric utility, to AIG bonds which offer three times upside and are senior to the government's investment, to list just a few. In short, we have used this volatility both to capture some short term gains, (which has helped offset some of the losses that will not recover), add to senior holdings that offer very compelling risk/ reward, and to create exposure to high quality names that should provide very solid gains over the next several years.

We have been through this before. It is difficult and trying, but in the end it creates opportunity. Sentiment in the markets changes fast and the market moves before the economy does. Merely fifteen months ago the averages were touching all time highs. As quickly as we saw investor panic bring stock prices tumbling down, the tenor will change and the market reaction will likely be dramatic. Given current levels of pessimism, the surprises in the year ahead are likely to be on the upside.

—Charles Lemonides, CFA

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ValueWorks
critical thinking. independent research.

Defining our Philosophy:

At ValueWorks we define value investing as buying the best-quality assets at the best possible prices. We like to think of ourselves as bargain hunters: it is our goal to pay only $0.50 to $0.75 for $1.00 worth of assets. We evaluate the component parts of a company, assigning each of its assets a dollar value that, when added together, comprises the underlying value of the company; if this is higher than the company's stock price, we consider it an investment opportunity.

Defining our Process:

1) Identification. We monitor the financial markets to identify securities that match our investment criteria—focusing on opportunities that appear misunderstood by the general market.

2) Appraisal. First we identify the assets; then we appraise them. This allows us to determine the company's *underlying value*. We then decide whether the assets are of high quality and therefore likely to appreciate over time.

3) Assessment. Here we assess any claims against a company's assets; we then compare the market price of the claims to the company's *underlying value*. If a particular security trades at a discount, we identify factors that could eliminate the valuation gap and increase its price. We then make a decision on the purchase of the security.

4) Re-Evaluation. We continuously monitor our positions to determine if our original investment thesis still applies, taking necessary action to optimize our portfolio.

5) Exit. We exit a position when a security either reaches full valuation or changes in its outlook invalidate part of our original thesis.

Our objective is uncomplicated, but achieving it requires a high level of research, expertise, discipline and independent judgment. By applying this framework consistently we remove emotion from the investment decision making process, enabling us to capitalize on inefficiencies built into the market.

About our Portfolio Structure:

We believe risk can be better contained through educated security selection than through overdiversification. Consequently, our position sizes range between 3 – 5 % of the overall portfolio value. Fully invested portfolios tend to hold 25 – 35 individual investments.

We enter investments that we view as 25 – 50% undervalued and sell them when we see them as fairly priced. Our anticipated holding period tends to be one to two years which results in only modest portfolio turnover.

Because our decisions are based on research and sound fundamentals we view depressed price action on our securities as buying opportunities rather than sell signals.

We use senior debt and preferred instruments—offerings that can be easily misunderstood by traditional equity or fixed income investors—to gain equity type returns on safer vehicles.

About our Client Services:

ValueWorks provides independent investment management on an individual account basis. Our clients receive the benefits of owning securities directly, coupled with the advantages of having a dedicated portfolio manager.

Working directly with your financial consultant, we evaluate your investment profile and build a plan designed to meet your specific goals.

As a high-end investment alternative, you receive:

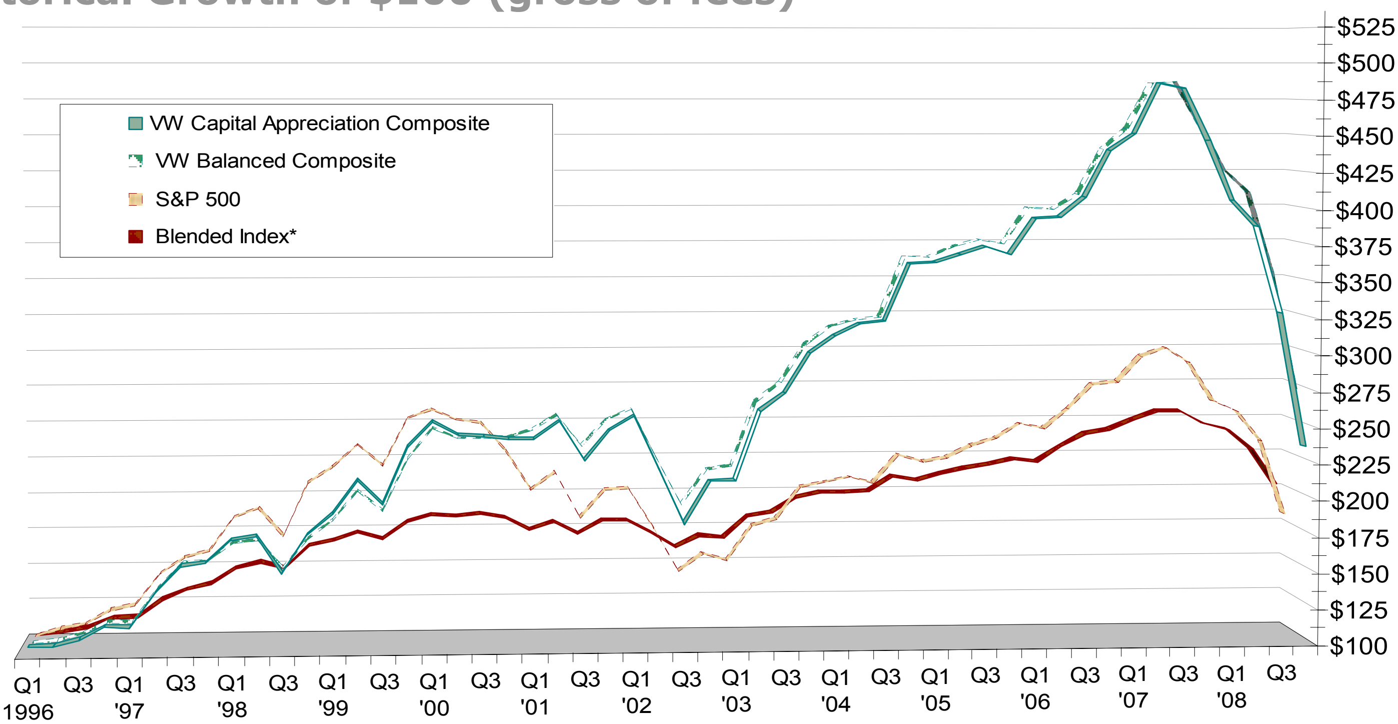
- Individual review of your portfolio requirements
- A separately tailored portfolio created and maintained to your investment objectives and risk tolerance
- Access to the Portfolio Manager on an ongoing basis with timely and responsive communication
- Flexibility to meet your changing tax requirements and investment needs
- Comprehensive quarterly performance reports.

Working within the framework of our value investment discipline, we build portfolios that cover a wide spectrum of risk-tolerance, from aggressive to much more conservative and income oriented.

ValueWorks Performance Review

4th Quarter: September 30, 2008 —December 31, 2008

Historical Growth of $100 (gross of fees)



Trailing Performance Data

	ValueWorks' Capital Appreciation Composite			ValueWorks' Balanced Composite		
	Gross of fees	Net of Fees	S&P 500	Gross of fees	Net of Fees	Blended index*
10 year	2.72	1.25	-1.36	4.62	2.92	2.15
7 year	-0.81	-2.20	-1.51	1.00	-0.57	1.74
5 year	-4.79	-6.10	-2.17	-2.24	-3.69	0.80
3 year	-13.81	-14.98	-8.35	-9.99	-11.34	-2.35
1 year	-47.02	-47.74	-36.96	-40.29	-41.20	-20.47

*The "Blended Index" is a calculation comprised of 50% S&P 500 and 50% Merrill Lynch Domestic Master Bond Index.

The above benchmark indices are unmanaged indices. The benchmark performance numbers reflect the reinvestment of dividends and interest but do not reflect the deduction of any fees or expenses. ValueWorks' value investing style is not limited to the securities in any of the above indices and utilizes specific investment techniques which are not utilized in the above indices and which may or may not increase volatility. Returns include all dividends, interest, accrued interest and other cash flows received as they may result from the implementation of a particular investment strategy. Trade date accounting has been used. Results for the full period are time weighted. Accounts are included in composite at the start of the first full period under management. From 1996—Q1 1998 exiting accounts are included through the period in which they left. Starting in Q2 1998 exiting accounts are included through the last full period under management. Results were generated at other firms prior to 9/30/01. Information on other composites is avail-

As of 12/31/2008 the Capital Appreciation Composite consisted of 311 accounts and $58,432,964 in assets; while the Balanced Composite consisted of 91 accounts and $33,005,544 in assets. Together this represents 99.01% of total accounts and 81.85% of total assets.

Past performance is not a guarantee of future results.