
SEPTEMBER 2008 QUARTERLY REVIEW

WHERE WE ARE

For the quarter, the S&P 500 was down -8.37%, and it is down -19.29% year to date. For the same periods, the MSCI World index total return was -11.39% and -22.75%, respectively. The MSCI Emerging Market index was down -20.90% for the quarter and -30.70% year to date. High-grade corporate bonds, mostly by financial institutions, witnessed a highly unusual -8.58% return for the quarter and are down -12.23% year to date. Long-term Treasury bonds had a positive +3.45% return for the quarter and are up +4.94% year to date, illustrating the panic “flight to quality” that continues to characterize world markets. Commodities had a -27.88% return in the quarter as investors aggressively sold natural resource stocks and bought selective financial stocks, which rallied in the quarter from very depressed levels. Gold, a strong performer over recent years, returned a -4.92% in the quarter. The winners for the quarter were the U.S. dollar, government bonds, and cash.

During the first ten days of October, ALL of the world’s stock markets were down an amount approximately equal to their year-to-date decline through the first three quarters of 2008.

Through October 10, the S&P 500 is down -37.71%, and it is down -40.90% from its October 11, 2007 high. Emerging markets are down over -50% year to date and about -52% from their October 31, 2007 highs, while the MSCI World index is down -45% year to date and about -51% from its October 31, 2007 high.

We are clearly in the middle of a global financial crisis. The root of this crisis is the collapse of the U.S. housing market caused in large part by Alan Greenspan’s easy money policy that was necessary to rescue the economy from the technology bust and stock market collapse in 2000. Wall Street figured out how to become an unregulated bank (Shadow Banking System) and took advantage of the low interest rates and the government’s encouragement to support the housing market. Mortgage brokers and unqualified home buyers then figured out how to take advantage of Greenspan’s low interest rates, Wall Street’s “bank”, and the government’s complicity by buying houses and agreeing to mortgage terms that did not make sense. These mortgages were packaged into CMOs and many were assigned an AAA rating and sold around the world.

The United States is in a recession, which probably started in June or July. Europe and Japan are also in a recession, and the high-flying emerging markets are not far behind. Consumer net worth in the United States fell 9% in the third quarter and is on track to fall at least another 12% in the fourth quarter. Unemployment, now at 6.1%, will

probably exceed 8%. Inflation is not an issue for now, and our concern should be in fighting deflation. Even NOMINAL GDP, not just REAL GDP (nominal GDP adjusted for inflation), could be negative sometime in the next two or three quarters. In our history, this is almost unprecedented and something that must be avoided in our highly leveraged world.

There is some positive news. We believe that central banks and policy makers around the globe are very aware of the current crisis and have the tools to eventually repair the global economy and financial markets. We saw a coordinated global rate cut, including China, on October 8. Henry Paulson's \$700 billion Troubled Asset Relief Program (TARP) was passed by Congress and then signed into law, giving the government a broad range of authority to buy troubled mortgage assets and unsecured commercial paper and to invest directly in troubled financial institutions. The government guaranteed money market fund holdings as of September 19, and the FDIC raised the insured limit on bank deposits to \$250,000. Wall Street's unregulated "Shadow Banking System" has been shut down. Oil and gas prices have collapsed, giving consumers a de facto tax cut. Inflation is plunging. Mortgage rates have declined but probably need to decline even more to 5% or lower. There is a tremendous amount of cash sitting in individual banking accounts, sovereign funds and Treasury bills waiting to be invested. (An investor cannot buy any Treasury bills through July 2009 at a yield greater than 1%.)

We are going through a very painful systemic deleveraging of the world's economies. Our capitalist system depends on trust, that trust has disappeared, and the credit markets are frozen. Banks will not loan to each other, let alone to consumers and small businesses.

WHAT WE NEED TO DO ABOUT IT

The credit market freeze is a worldwide systemic problem so we need to start with systemic solutions. Central banks around the world have already started by cutting rates; they will and should continue to cut these rates further. Governments around the world are starting to do their part; the U.S. Treasury's \$700 billion TARP is one example, but governments need to do even more. This is the time for a good dose of fiscal stimulus: increase the federal deficits and CUT TAXES. The Federal Reserve Bank and central banks around the world need to do more. They need to "print money" by buying mortgage-backed securities, commercial paper, and maybe even stocks. They should also guarantee interbank transactions to help free up the credit markets. This is especially true in Europe where Libor rates are skyrocketing. We are not a fan of government intervention, but it is in times like these that our elected officials need to cooperate, show some common sense, and adjust the balance of laissez-faire capitalism slightly toward the government side of the ledger.

History tells us that fiscal and monetary policy work and that systemic problems can be solved through systemic solutions, over time. The solution to our current crisis will not come quickly; it takes time for fiscal and monetary policy to restore confidence and launch a new expansion. Eventually, the necessary expansionary fiscal and monetary policy may lead to a rise in inflation, but that's a fight for another day. First, we must

put all of our vast resources into the unfreezing of the credit markets and prevent the world's economies from falling into a Japan-like recession or a 1930s-like depression that could last ten years or more. Essentially, all asset classes have declined in price over the last year. All asset classes don't have to constantly increase in value, but we certainly cannot have all asset classes decline in value in a leveraged world.

ANOTHER PROBLEM

Wall Street's "Shadow Banking System" is one of the major causes of our current crisis. Wall Street's unregulated "Shadow Insurance System" and the hedge funds that are the main participants also share the blame. Credit default swaps, Wall Street's name for unregulated insurance products, have been a major contributor to the demise of some great companies and a major contributor to the stock market's collapse.

Here is how a credit default swap works. A money manager, maybe a hedge fund, bought a credit default swap (insurance) on, say, Lehman Brothers bonds. They may have paid \$100,000 per year for \$10 million of coverage. They wrote a private contract with a counterparty that was willing to insure the bonds, maybe AIG. The agreement was not regulated or disclosed on any public exchange. Once the credit default swap was in place, the owner of the "policy" had some ability to make the counterparty pay off. They did this by shorting (naked short?) the stock of an already weak company, Lehman Brothers, driving up the value of their credit default swap and – in the case of Lehman Brothers – forcing them out of business and collecting on their "insurance" policy. This in turn put pressure on the insurer, AIG, forcing the government to loan them, AIG, over \$100 billion. They also made money on their short of Lehman stock.

It is difficult to overstate the repercussions that the bankruptcies of companies like Lehman Brothers had on our credit crisis. The credit default swap market has an estimated notional value of \$60 *trillion* dollars. Steps are being taken to rein it in and make it transparent by listing contracts on an exchange which would guarantee that the transactions clear and that a counterparty margin requirement would be maintained. You and I cannot insure our neighbor's house and then burn it down to collect the insurance. Essentially that is what many hedge funds did to Lehman Brothers.

MUNICIPAL BONDS

A large percentage of KCM's business is managing bonds. A large percentage of the bond money we manage is tax-free municipal bonds. We have received many phone calls from you asking if your bond portfolios are safe. We have always been "quality" bond buyers, in both the corporate and municipal market. Most all corporate bonds are showing some stress. Spreads have widened for all credits, including AAA-rated names like General Electric. This stress is likely to continue until the economy stabilizes.

We have had a number of phone calls asking specifically if California municipal bonds are safe. Frankly, California general obligation bonds are our favorite credit. We don't believe there is any risk of default; the words "General Obligation" and "Full Taxing

Power of the State” are comforting. Bill Lockyer, California’s State Treasurer, said on CNBC last week that the state constitution says California must pay “teachers and bond interest.”

Governor Schwarzenegger’s misquoted remarks that he was going to need a loan from the federal government because the credit markets have frozen up has put some upward pressure on California bond yields. There has also been some forced liquidation by leveraged municipal bond funds (some leveraged closed-end bond funds are down 40%!) of longer term municipal bonds in general and California bonds in particular. That has made the 20- to 30-year part of the California curve attractive.

Municipal bonds are also “relatively” attractive across the curve. Five-year California GOs are 110 basis points higher yielding than comparable Treasury bonds. Historically they have yielded about 75% of the Treasury bond yield; after all, they are tax-free and Treasury bonds are taxable. Actually, tax-free treasuries (pre-refunded municipal bonds) are yielding 50 to 90 basis points more than comparable maturity Treasury bonds! Sleep tight, your California general obligation bonds are safe.

At KCM, we are diligently reviewing clients’ exposure to their securities to help ensure that only quality securities with reasonable valuations are retained. We remain confident in municipal debt and find its wide spread to U.S. Treasuries a major reason to lock in current yields. We have seen tough markets before – such as the 1970s, the savings & loan crisis, the Asian credit crisis, the Long Term Capital crisis, the 1987 crash, and 9/11 – and there has always been a light at the end of the tunnel. The government and the private sector will ultimately find the right strategies that will free up credit and promote growth. Only long-term investors with proven strategies win in these situations. KCM remains in that camp.