



A DISCUSSION ON THE IMPLICATIONS OF INTEREST RATES AND
THE VALUE OF THE U.S. DOLLAR TO THE INVESTMENT MARKETS

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A Discussion on the Implications of Interest Rates and the Value of the U.S. Dollar to the investment markets

As we mark the 20 year anniversary of the market decline of 1987, I am reminded of the events of that day and their effects on the market. I was in my third year of managing an equity mutual fund and I remember it like it was yesterday. The declines were severe and the fear in the marketplace was more extreme than I have experienced since that date. Yet, the effects were transitory and the decline was brief. People forget the market finished up for the year and the bull market continued until the technology bubble finally burst in 2000. This bull market was aided, in part, by what became known as the Greenspan put, and it was first used following the steep decline of October 1987.

What do we mean by the Greenspan put? Following the market decline of 1987, the U.S. Federal Reserve lowered interest rates and provided considerable liquidity to the markets to help investors recover from the effects of the equity decline. In many ways this helped lay the foundation for the subsequent bull market. There were subsequently other occasions where Federal Reserve easing helped to maintain the bull market.

I am reminded of these events by the recent action in the U.S. equity markets. The markets sold off severely as investors became concerned about the effects of the troubles in the subprime mortgage market. The response of the Federal Reserve was to lower rates quickly and decisively. The ½ point decline engineered by the Fed has been credited for the quick recovery of the market and its subsequent recovery to record levels in the Dow Jones Index and the S&P 500.

The recent market action has given me reason for pause. The question I have been asking myself is, “What if there is market turmoil and the Fed does not ease?” Even worse, “What happens if they tighten in the face of market decline?” The obvious response to that is to simply ask why would the Fed do that? Clearly, it is something the Federal Reserve would not want to do but market events could force their hand. This is not unprecedented. In the late 1970’s and early 1980’s the central bank was quite restrictive in the face of a weak economy due to high and rising levels of inflation. This was very painful and not something the Fed wanted to do, but was necessary to set the stage for long-term prosperity. This also coincided with a severe bear market in equities so it is an important factor to monitor.

If this is not something the Fed would want to do, what is it that would cause the Fed to respond in a restrictive manner to market volatility? I have been monitoring several indicators which might lead to this response and chief among them is the value of the dollar. I have included a graph showing the long-term decline in the value of the dollar at the end of this letter. The U.S. currency has been in a multi-year bear market and the latest Fed easing only accelerated the decline. If the Fed perceived further easing would exacerbate the dollar’s decline, it may be restrained in responding to market declines. The dollar’s value is especially important because the U.S. is an importer of capital. Foreign investors may be reluctant to continue investing if the market decline continues.

We are also monitoring inflation indicators in case rising inflation could create a cautious Federal Reserve. Right now those indicators are mixed. Inflation, as measured by the CPI, is relatively tame. However, PPI inflation is more troubling. The PPI is impacted much more severely by rising commodity prices. To date, we have seen significant increases in commodity prices with very little increase in inflation. If this acceleration in the PPI inflation measure is a precursor to future increases in inflation, then the Fed's job becomes more difficult.

While we have been monitoring these indicators for some time, this issue is much more topical as the recent Fed ease triggered a significant market rally. We are concerned that investors are becoming complacent and we wanted to highlight these important issues to our shareholders. We will continue to monitor these indicators, but we wanted to inform you of these important concerns regarding the opportunities in the equities markets. Currently, these are only concerns. However, if these currency or inflation indicators become more problematic it could create difficulties for the equity market.

U.S. DOLLAR INDEX FROM DECEMBER 1999 THROUGH OCTOBER 2007



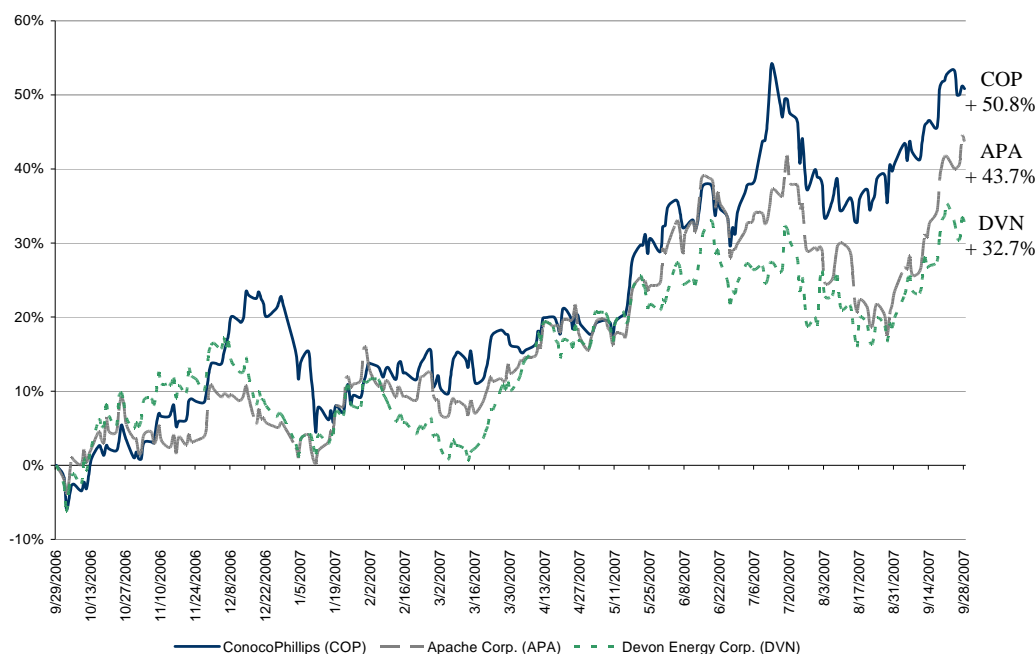
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An Update – One Year Later

A year ago, we communicated our thesis and reasoning for continuing to hold a large percentage of our portfolio in energy related businesses. At the time, crude oil and natural gas prices had fallen to recent lows and our investments had followed. Our decision to continue holding our positions (and subsequently adding to them) may have seemed controversial at the time; however, as we explained in our letter last October, we were simply following our investment discipline. Upon re-assessing our estimates of intrinsic value, we concluded that our stakes were trading at larger discounts to intrinsic value.

Over the past year, energy market fundamentals have tightened and commodity and stock prices have rebounded. As a result, our energy holdings have been a significant contributor to positive performance in our funds. For example, the three largest energy holdings in many of our funds are Devon Energy, Apache Corp., and ConocoPhillips. The 12-month total return (9/29/2006 thru 9/28/2007) for these three stocks is shown in the chart below:



We have always emphasized to our clients that we follow a disciplined intrinsic value approach with a long-term perspective and recommend that clients share our philosophy. While admittedly over a short period of time, this is one example when our strategy was very successful. We may find it necessary in the future to again invest in a controversial situation when the long-term opportunity justifies the investment. Not all such investments will be this successful. However, finding true long-term value often requires we invest in areas of short-term uncertainty.