THE RIDGEWOOD GROUP

The Art of Intelligent Investing℠

October 17, 2008

Dear Valued Clients and Friends,

It has been one month since we sent out our last client communication on September 15, 2008 - the day that Lehman Brothers filed for Chapter 11. Normally, very little happens in a month in the markets and economy. However, this past month has been filled with events and emotions of an extreme nature. It feels almost like each week is actually a "dog week" corresponding to a month or more of "normal" time compressed into seven days. Faced with this barrage of activity and emotion, it would be easy to feel overwhelmed, as we are sure many are. Therefore, we are writing to you again with another update.

Our sincere hope is that this update will help give you some more clarity with which to process the current environment. Though we may not succeed entirely, we are striving to present to you a realistic, nuanced, and balanced view – one that may be difficult – if not impossible – to find through the mainstream media.

Before elaborating on the general environment, let's start by stating the obvious. Almost everyone who is currently invested in equities (other than those selling them short – i.e. betting on a price decline), whether in the US or International markets and whether through individual stocks or mutual/hedge funds, has recently experienced a "breathtaking" decline in the "value" of their investments. Year to date, the S&P 500 has declined around 35% and internationally, the results in dollar terms have been even worse this year.

If you have been investing for a long enough time (more on that later), the recent decline has, for now and on paper, erased some portion of the gains that you had accumulated until now. On the other hand, some of you may have only started investing in the last two or three years and/or added funds into your account in that time frame so the recently decline may mean that at current mark-to-market (more on this term later as well) account values your investments may appear to be uncomfortably (maybe even frighteningly) lower than before.

In part because of prior excesses described in our last letter and also because recent events have scared and or surprised so many, there has been a cascading crisis of confidence. Ultimately, it is confidence, and not mainly liquidity that is at the heart of the world's current financial panic. Though some proclaim otherwise, our problem is not that there is a shortage of money in the world. In fact, there is plenty of money in the world's financial system[1] (and more being added each day due to the tremendous interventions by governments and central banks). The real issue is that because most people are suddenly wracked with doubt and fear stemming from a shocking (to them) series of unexpected events, much of this money is being withheld from its normal pattern of being spent, lent, and invested. Given the ongoing adjustment away from a period of excessive credit and lax underwriting, some change in behavior was necessary and healthy. However, to the extent that extremes of pessimism have now replaced the prior extremes of optimism, the crisis of confidence has temporarily made the situation worse than it needs to be.

Suddenly, institutions and individuals are fleeing all forms of risk and uncertainty (either actual or perceived) either because they have to or because they are afraid. The practical mechanism for this to occur is that those who own "risky" assets like stocks or loans are selling them or demanding repayment. We put "risky" in quotes, but it is the perception of risk rather than the actual long-term chance of loss that is relevant. In many cases, the assets being dumped with abandon would actually have been decent long-term investments if held.

Sellers today are acting like a crowd of people all trying to exit a theater through the same small door after someone yells fire. In this situation, the resulting stampede can be unnerving, irrational, and even dangerous. Ironically, if the fire isn't a raging inferno already or if in fact there is no fire, then the stampede due to fear can actually be more dangerous than the fire itself. The financial system depends on confidence and without it the system would grind to a halt or worse. Recognizing this threat, the federal government has unleashed a series of steps to help restore confidence.

This "technical" selling by investors explains why stocks (and many other assets including many bonds) have fallen so far so fast in September and the first two weeks of October 2008. Due to a system wide reduction in leverage, market participants like hedge funds and mutual funds are currently forced sellers.

---

[1] One indication is that short-term treasury yields are lower than they have ever been. Short term treasury bills like 3 month T-bills are trading right now to offer an annualized yield of less than four tenths of one percent and were very recently yielding zero percent. Since interest rates are set by the supply and demand for money, this is one of several barometers that the supply of money in the world's financial systems is high.

In the case of hedge funds it may be because their brokerage firm (maybe even Lehman Brothers) engaged in a margin call and they have to sell assets to meet those margin calls. In addition, most hedge funds allow investors to pull out their money every month or quarter. So even if they don't want to sell, they have to sell in order to meet their redemption obligations to their now panicked "investors."

With mutual funds, the process is even quicker. All redemption requests received prior to the close of the market have to be fulfilled by the next morning. Of course, the people running the funds try to sell their holdings in an orderly manner, but if they underestimated how much cash to keep aside on a given day, they have to scramble at the end of the day to sell enough to meet their wire transfers the next morning. This explains why there were such big downward swings in the last hour of trading on many of the trading days in the last few weeks.

What is notable about the above two types of sellers is that they are completely price insensitive sellers in the circumstances described. *Once the margin call or redemption request comes in, they have a non-negotiable obligation to deliver the net asset value of the fund or the amount of the margin call without exception, and therefore they will sell at any price*. Of course, for every transaction there is always a buyer and a seller – a fact which sometimes seems to elude the mainstream media commenting on market declines.

For each share someone sells, someone else, by definition, is buying because they think it is a fair purchase. If there are not enough takers at a given price, the price declines enough to entice someone to step up to the plate. That is what is happening at a more rapid pace than we might normally expect.

This brings us to the mark-to-market nature of current valuations. It is indisputable that on a given day, every security that trades in the markets with any volume of activity, has a price at which someone is willing to buy and a slightly different price at which someone is willing to sell. From an economics point of view, this price is set by the marginal buyer/seller who is willing to enter into a transaction at a given moment.

If the marginal seller is desperate or compelled by circumstances (as many are today) whereas the marginal buyer is skittish (and apprehensive about the potential for further declines) that price will tend to go down. Note that even though a very small fraction, *usually much less than 1% of the outstanding shares of each company, is traded on a given day*, this is the reference (or mark-to-market) price that is used to value all the other identical shares that were not transacted and not offered for sale that day.

It should be obvious, and empirically verifiable, that the market prices of securities will be much more volatile and dynamic than the underlying value of the assets and businesses in which the security is but a fractional interest. The market price is an opinion on value, where as the actual value can only be ascertained by the sale of the assets or businesses in question (a relatively rare occurrence). As an opinion, it is susceptible to both news and emotions. In times of stress, when emotional factors and forced selling are predominant, it is much more likely that market prices can adjust more than justified by economic and business developments.

More so than at any time (in a long while), we believe that market prices today have become attractively low, either because the marginal buyer and the marginal seller are overly emotional and pessimistic or because there is an excessive amount of forced selling. The S&P 500 index has declined approximately 34% since December 31, 2007. The S&P 500 index basically represents diversified ownership of 500 of the largest public companies headquartered in the US, and therefore is a proxy for a collection of some of the largest and "best" companies in the world.

Investors should ask themselves whether it makes sense that these five hundred companies are, collectively, worth more than one-third less than they were about 1 year ago. Of course, the economy may be heading into recession and earnings are likely to temporarily decline, maybe severely and for several years in a row, but relative to interest rates and inflation as well as the likelihood that the most severe of our current issues, particularly the crisis in confidence, are likely temporary issues, it is difficult to reconcile the big decline in market price of the index this year with the likely slower depreciation in the value of these same five hundred companies due to an adjustment in their long-term asset values and free cash flow prospects.

True to form, many investors panic when market prices fall, probably because they extrapolate price declines into the future. So they sell investments they would otherwise have held onto for 10 or more years if the market had been closed. This panicked selling is often mainly a reaction to the fear and panic exhibited by others. History demonstrates, fairly conclusively, that this type of chain reaction tends to take on a life of its own. The current panic selling reminds us a bit of the mindless panic buying of dot com and tech companies back in 1999 - the emotion, magnitude and irrationality is the same, only the direction is different. Acting on emotion did not make sense then and it does not make sense now. Someday, we predict that investors who sold (by design or necessity) in a panic last week will probably berate themselves – as others have in past bear markets – for making a short-sighted emotional decision in the heat of the moment.

The Ridgewood Group
The Art of Intelligent Investing℠

We do not want to minimize the real issues and adjustments that are obviously occurring and yet to come, especially the strong likelihood that a recession in economic activity perhaps longer and more severe than any of the ones in recent experience, is likely or already here. We recognize that current events are very scary and uncomfortable and as we described in our last letter, the adjustment process of deleveraging and better risk underwriting is necessary but will lead to some pain. Given the scars of the current financial panic as well as a much more restrictive regulatory environment on the way, banks and lenders will be much more circumspect going forward and interest rates may even rise. Disciplined lending will have to dampen asset values, employment, and consumer spending for quite a while.

However, the current selloff is very similar to many other panics that have happened in the past, a number of them actually occurred prior to the crash of 1929 (including the panic of 1883, and the panic of 1907). A prominent economist has noted that "The most important thing about financial panics is that they are all temporary. They either die of exhaustion or are overwhelmed by the heavy artillery of government policies." We do not see any convincing reasons why this time should be any different, and the government's war against the panic is already well under way.

Of course, every time there is a bear market (the current one being the 10th or 11th in the last 50 years), a nagging voice of fear whispers the inevitable suggestion in your ear: maybe this time is different. The rational investor knows that every bear market has been followed, eventually, by a bull market that makes up the losses and generates additional gains. But in the emotional epicenter of the panic it is easy to doubt history and ignore reason. Since they say a picture is worth a thousand words, we encourage you to view a great presentation available online called "Is this time different?" (Short Answer: NO – for the longer answer, access the full version at http://www.dfaus.com/library/videos/different/).

The notion that markets reward patient investors (especially value investors) and that they bounce back from seemingly unbelievably terrible events has been tested again and again. The most severe test this century (under different and worse circumstances) occurred from 1929 to 1932. The market fell four years in a row, ending that stretch of time by a decline of approximately 90%, but in the next 4 years (had an investor held on) the market recovered almost the entire loss. Back then, the issues were worse and there were fewer safety nets. Unlike today, there was no FDIC, no IMF, no SEC, and an inept government response. The market was overvalued in the late 1920s (prior to the crash) and due for a fall. Nevertheless, an investor buying at the peak would still have been ok in the end (it just took a while). An investor who averaged in did even better.

History demonstrates that equities sometimes go sideways for an extended period of time. The majority of severe bear markets start after a five or ten year period of supra-normal returns leading to notable and relatively obvious overvaluation when compared to interest rates and inflation. This overvaluation is then appropriately followed by a sideways to down market, sometimes short and severe and sometimes drawn out and less acute. Such markets tend to overcorrect until all but the most disciplined investors are scared away or washed out and valuations are too low – creating the environment for the cycle to begin anew.

At the start of the current crisis, we were not at one of these points of extreme overvaluation. With interest rates so low and inflation relatively under control, the market at the beginning of 2008 seemed neither excessively over nor undervalued (though some would argue otherwise). However, because the S&P 500 was so overvalued in 1999, if you had invested in the S&P 500 at beginning of 1999 and held on through mid October 2008 your 10 year return is now close to zero.

This fact is probably discouraging to all the investors who were told (and believed) in the late 1990s that all they had to do was buy the S&P 500 index fund to be guaranteed enticing returns forever. The fact that reality had turned out to be very different from what the majority of people expected and believed 10 years ago is hardly surprising.

The market was aptly characterized by one prominent investor as The Great Humiliator. Understood in this sense, the market is a complex, dynamic, and adaptive system. It is smarter than most of the people that make up the market and it eventually tests participants convictions and discipline through extended trials by fire. Since the market is smarter than most, it makes sense to be humble because the market is great at humbling those who think they have it all figured out. Although the market is difficult in the sense described above, it also operates according to some basic principles and rules which can be harnessed by successful investors to enjoy great results. Some of these basic principles are:

- Over time, the market rises along with the growth of the US and global economy, which over time always grows in both nominal and real terms due to a combination of factors like population growth, capital formation, productivity improvements, trade, inflation and innovation
- The majority held conventional wisdom is usually negated (at least temporarily) once enough people accept a given belief as self evident, so successful investors need to be independent thinkers and actors
- Valuations matter – those who buy cheap eventually prosper

- Patience is rewarded generously. If you are too greedy or in a big hurry, you have a greater chance of losing
- Reason and time are the friends of intelligent investors - emotions and impatience are their enemies

The above fundamentals regarding successful investing in the market explain why Warren Buffett's most important single piece of advice to investors is to "be fearful when the world is greedy and greedy when the world is fearful." Mr. Buffett has a lot of notable sayings that are celebrated in word, but far less often in deed. In particular, panicked sellers today seem to be operating on the motto to be "fearful when the world is fearful and greedy when the world is greedy" – the exact opposite of what they ought to do and a course of action that will, ultimately, make them far poorer than if they did nothing at all.

The world is finally fearful, and investors today only see a bogey man around every corner. In this environment, it would be a big mistake to liquidate, even if next month is going to be worse than this one from a mark to market perspective. History does not repeat, but it rhymes. The current experience is probably more comparable to the 1973/1974 bear market than any other bear market since. At the time, people started to question the wisdom of owning equities (i.e. of partial interests in businesses). Of course many of the other factors involved may have been different, but the psychology and reaction of investors going through a severe battering was probably very comparable.

Anyone who had the cash (and courage) to buy once in a generation values during the rout was eventually rewarded with exceptional returns. However, it is only an exceptional investor who can keep his/her head while the majority of others lose theirs. In the world of a few months ago, the majority of investors (including many professionals) had an entitlement mentality. They felt entitled to easy gains with no wait and no pain.

Predictably, there are few who have the will or the commitment to stay the course and even fewer who have the courage to buy. Last week had the hallmarks of widespread forced selling by certain institutions and mindless fear-based liquidation of equities by many funds and individual investors. The values now apparent have not existed in the last 16 years since we've been investing, either personally or professionally, so it is reasonable to be a lot more optimistic about the next decade than would be justified based on the experiences of the last.

Of course, bad markets are no fun, but they are necessary. Without them, there would be no discipline and no reward to those who exhibit the qualities that reward long-term success in investing. Without them, every tyro would be anointed a genius in investing. Most importantly, without them, the occasional opportunity to buy truly exceptional companies or investments at unbelievable bargain prices would never present itself. If you have the cash and the courage, it is an ***exceptional*** time to engage in a new investment program based on value equities or to add to your current investments. Even if all you do is sit tight and wait, we believe you have reason to be optimistic that the market will, eventually, reward your patience and resolve.

Thanks again for your trust. If you have questions or wish to discuss any aspect of this letter or your relationship with us please email us or call at any time.

Sincerely,

Ahalya Nava Kaushal "Ken" Majmudar

P.S. Warren Buffett contributed an Op-Ed piece in today's New York Times called "Buy American. I am." Though we wrote this letter in the few days prior to the release of his op-ed earlier today, it touches on some of the same themes. It features his usual mix of sagacity and wit, and we highly recommend it to you. To read the op-ed, go to: http://www.nytimes.com/2008/10/17/opinion/17buffett.html