The Ridgewood Group
The Art of Intelligent Investing℠

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As described in greater detail below, 2008 was the most painful year for investors, in terms of investment value declines, in at least the last three decades, and by some metrics, since the 1930s. We are writing to you in this, our third letter since September 2008, as economic and other market developments have warranted more frequent commentaries to our clients.

Obviously, these are emotionally trying times for most investors. Though difficult, it is more important than ever to resist the urge to make emotional decisions and instead continue to think about and act according to reason and intellect. Education and awareness are crucial if we are to succeed in this objective, which is why we write these letters to you.

While there continue to be some surprises in the details of how the recession and markets may be processing each new development, the current recession and economic crisis (and stock market reaction) are playing out along the lines that we have outlined in our past letters and as further discussed herein.

The Madoff Fraud

On December 10th, the now infamous Mr. Bernard Madoff confessed that he had engineered a multi-decade Ponzi scheme that bilked investors from nearly $50 billion. He did not confess voluntarily. Rather he was driven to admit to his massive fraud because market disruptions had forced a number of his "investors" to request more than $7 billion in withdrawals by the end of 2008. This amount overwhelmed his available sources of liquidity and he realized that he was about to be exposed within a short period of time.

Our investments at the Ridgewood Group have nothing to do with Mr. Madoff or his firm. Our clients keep their assets at reputable third-party firms like Fidelity and Ameritrade. These firms independently send statements and confirmations without our involvement. In contrast, Mr. Madoff registered his own broker dealer which allowed his firm to act as the sole custodian of client assets. He abused this structure to generate fictional statements presenting assets and returns that were not actually real.

Unfortunately, his fraud continued basically without much scrutiny, since client requests for cash or securities were always promptly met (from funds raised from other clients). The scheme remained viable over many decades because as his reputation and following kept growing and the number of new clients and new client investment inflows always exceeded any outflows. It was a game in which the music continued to play (and grow louder) – until the end of 2008 when it finally came to an end.

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Though he was not a very well-known figure in the world of investing, we'd heard of Mr. Madoff already. Four years ago, a friend had mentioned him to us and indicated that Mr. Madoff had an amazing track record. This friend was seriously considering investing with "Bernie", as he was known to his many admirers and clients. Also alluring was that investing with "Bernie" was a privilege available to the select few. At the time, we were skeptical of the opaque nature of his "strategy" and returns. Even superficially, the returns seemed too good to be true. Unfortunately, he and many others invested large sums with Mr. Madoff.

The great Jewish-American investor Bernard Baruch, who served as an advisor to several U.S. Presidents, observed that "the only people who always buy at the bottom and sell at the top are liars." What Mr. Baruch meant is that if an investor always claims to have such great timing that he or she always knows just when to act to sidestep losses yet consistently makes money, he or she is probably not telling the truth.

Savvy investors know that securities prices fluctuate, sometimes violently, and that while a sound investment portfolio and the market will rise in the long-term, markets also experience many temporary and occasionally severe corrections too. The Madoff scandal reminds us that there is no free lunch in investing. Taking shortcuts or pursuing returns without risk exposes gullible investors to the many charlatans who can and will pretend to be legitimate miracle workers when they are actually frauds.

Mr. Bernard Madoff's scheme was irresistible to his many investors precisely because he offered them a shortcut to riches with the emotional comfort and regularity that people crave. They *wanted* to believe in Bernard Madoff's promise of attractive market beating returns while being spared the emotional discomfort of downside during even severe bear market moves. Also attractive was Mr. Madoff's exclusivity, his investors were made to feel a part of an anointed club of lucky investors with access to Mr. Madoff's acumen.

Inexplicably, the U.S. Securities and Exchange Commission, which regulates broker dealers like Madoff's firm, received many warnings that Mr. Madoff's disclosed returns could not be legitimate based on the strategy that Mr. Madoff described. Unfortunately, these warnings did not trigger an extensive investigation of Mr. Madoff's operations – allowing the scheme to continue far longer than necessary. Ironically, in an era during which Washington and the Federal Reserve are increasingly intervening in the economy (sometimes unavoidably) and in private markets, the SEC's mishandling of its regulatory function in this case illustrates the limits of government competence, even when the mandate is rather well defined.

As troubling as recent market returns have been for long-term investors in a year like 2008, they look palatable in comparison to the catastrophic experiences of Mr. Madoff's victims. For the most part, our 2008 unrealized "losses" are temporary and, *if we are patient*, our account values should recover in time. Many of Mr. Madoff's victims will be fortunate if they *ever* recover even a fraction of their "investment" dollars. As Erasmus once quipped, "In the land of the blind, the one-eyed man is king."

A Quantitative Review of the Current Bear Market

Judged by the high point on the Dow Jones industrial Average ("Dow Jones") and the Standard & Poor's 500 Index ("S&P 500"), the current bear market began around October 9, 2007, when the Dow Jones peaked at 14164.53 and the S&P 500 at 1565.15. Recently, a panel of economists also declared that the current recession in economic activity officially began only a few months later in December of 2007.

Since then, the market has fallen faster and in a shorter period of time than in any comparable period since the S&P 500 index fell 43.4% in 1931 (part of a 4 year 89% decline from the 1929 market peak). The total declines in these indexes have been particularly severe since September 2008, seemingly related to the timing of the bankruptcy of Lehman Brothers.

Since the peak in October 2007, the S&P fell 42.29% to a level of 903.25 on December 31, 2008 (excluding dividends) and the Dow fell 38.04% to a level of 8776.39. In January 2009, both indexes fell again and the S&P 500 fell 8.4% in January 2009 alone – its worst performance in a January in history - widening the total decline since October 2007 to 47.2% since the bear market began.

Notable about these horrible bear market declines is how uniformly bad markets have been both in the US and around the world and in a variety of asset classes and sectors. In part, the reason that declines have been so widespread is that the current market prices are being driven downward by many investors simultaneously selling assets and raising cash out of fear.

The only exceptions in terms of better performance in this bad market have been selling stock short (i.e. betting on a price decline), holding cash, or investing in long-term U.S. Treasury bonds which rallied to rise more than 20% last year (and, in our view, themselves reaching unsustainable valuations) as interest rates have dropped and investors have rushed to the perceived "safety" of treasuries.

While we largely avoided owning highly leveraged financial companies and other speculative investments, and focused our efforts on companies and investments offering value with relatively conservative balance sheets, our portfolios have also declined significantly. Although our investment portfolios have outperformed the market as measured by the S&P 500 index during this bear market and also since inception of each of our strategies, having relatively better returns when market returns are so poor is still painful. Ultimately it is only the realization of positive returns that will alleviate this pain.

Most value investors recommend focusing on the long-term because pursuing short-term returns usually requires employing trading and speculative strategies that often do more harm than good if you have a long-term investment horizon. As is apparent by market returns between 1998 and 2008, even someone investing over the last 10 years did not generate a good result, even before adjusting for inflation. The nominal return on the S&P 500 index was -1.38% per year including the reinvestment of dividends. This is extremely low by any historical or logical yardstick. In fact, the 10 years ending December 2008 offered the lowest 10 year return in the history of the S&P 500 including all the 10 year rolling periods that include the great depression. Of course, the 1998 to 2008 "decade", is an unusual period bookended by a boom (with overvaluation) at the inception and a bust (with undervaluation) at the conclusion.

Cash On the Sidelines at Record Highs

Investors who have experienced the last 10 years of negative returns are demoralized (almost every investor seems to be these days) and many are giving up their investments at this point. By some estimates, approximately $8 to 9 trillion in cash is currently invested in money funds.

We believe that the amount of cash out of the market is actually a positive indicator for the long-term returns we can expect from current levels. Markets are mean reverting – i.e. bad periods are followed by good such that the average is close to the long-term average. Once we cross the chasm of the current severe recession, returns have to be higher than average in order for the average to approach historical levels. The large amount of cash sitting on the sidelines represents a deferred demand for assets (and securities) which, when this money returns to investment markets, could be the catalyst for market values to explode upward fairly dramatically – thereby reversing at least a part of the unrealized losses incurred in the current bear market so far.

Unfortunately, because the economic and earnings outlook is so grim in the near term, equity values may keep falling for a while longer. Between asset write downs and declining sales (and therefore negative operating leverage), the profitability of the companies in the market has been declining and may decline further still. Unemployment continues to rise, consumer spending is falling, and business investment is declining.

We have known for some time that the near term economic news could indeed be quite grim. We have not attempted to time a temporary exit out of equities for most of our long-term investment clients to avoid the market's recent woes. We mostly don't pursue such an approach because a.) valuation levels are and have been low and selling now makes little sense to us 2.) the consensus view is to hold cash and the consensus is usually wrong in the long-term and 3.) doing so could significantly increase the risk that we will get the timing wrong such that we lock in the downside, but rob ourselves of the recovery.

Why We Don't Make Market Predictions and Don't Act on the Predications Made by Others

Most of us know that the market is bound to recover – because there are economic and historical reasons that we discussed in our last two letters why they ought to. The only uncertainty is when it will do so – unfortunately this is not a trivial issue.

Time horizons matter. If market prices were to recover within the next 2 to 3 years, the outcome and effect on our lives would be different than if it takes 25 more years to do so (the latter however is very unlikely). Given this uncertainty, and the extreme emotional pain associated with staying invested in a bear market, most investors have already liquidated their assets and sit with their cash on the sidelines. They have either given up on investing for the foreseeable future or alternatively they intend to time their entry back into the market at a "better" time. It is a great concept except for one issue –this strategy is unlikely to work, except through sheer luck, and then perhaps only for a handful of people.

We are extremely skeptical when people claim they can predict, with any useful level of precision, where the market is heading in the near term. In July 2008, the price of oil was above $140 per barrel. During the summer of 2008 the vast majority of commentators were indicating that oil prices were going much higher. Energy was the must-own sector. It is difficult to remember any commentators who predicted sharp oil and gasoline price declines at any time, let alone within the next three to six months – yet the price of oil has already fallen back to 2003/2004 levels below $40 per barrel – which few experts either expected or predicted.

This is why we consider most of the financial press and television commentary to be entertainment rather than investment insight. As difficult as it may be to predict the price of oil, predicting the moves of the overall market is far more complex. It's not a task that the so called expects actually can handle. Those of us engaging in a sensible investment program over a long-term horizon have an alternative to relying on random predictions or momentum. As Mr. Buffett has stated, investors should focus on things that are important and knowable (i.e. things we can both analyze and control). These fundamentals include focusing on investing when market valuations are attractive, not buying on margin, thinking independently and maintaining a long-term horizon.

The Market is a Complex Self-Healing System of Resource Allocation

As described in our past letters, the current crisis is the consequence of bad incentives and bad behavior that mutually reinforced each other over a number of years. As we've summarized before, the main culprits in this current economic downturn are bad underwriting, too much borrowing, and unsustainable consumption on the part of some institutions and individuals. When the credit was flowing freely, the boom resulted in a feeling of prosperity driven by overinvestment in areas like housing and financial engineering.

This boom encouraged bad behavior (including enabling massive frauds like Madoff and the more recent Satyam affair in India – with more likely to be uncovered this year). In our world, poor choices have consequences for those making the poor decisions. The fact that they do should not be a surprise. The good news is that the causes (bad behavior) *can and will* change if we let them.

Despite their imperfections and excesses, markets, *if they are allowed to function,* do a pretty good job of efficiently allocating society's scarce resources to generate useful goods and services. In a recession, production and employment *temporarily* decline as inventories are worked off and people refocus their efforts on the new areas of need. This is why recessions and bear markets are *never* permanent (usually they are relatively brief though this time could be one of the rare exceptions).

Markets generally have the capacity to heal themselves without external interventions. The exceptions occur when the machinery of the market itself becomes impaired as for example when something causes a widespread loss of confidence in the financial system. A number of large financial institutions and many others acted so irresponsibly in the last decade that a number of them would have collapsed without government intervention. Given that financial institutions are so critical to the functioning of a healthy economy, governments have intervened to save them. These interventions have been designed to either prop up at-risk institutions and/or cushion the pain in the "real" economy.

Unfortunately, large-scale government interventions nearly always have massive unintended consequences but legislators rarely focus on these unintended consequences, because they will usually not become pressing issues until a later time. As it intervenes, the government has been blaming private markets as the cause of the current bust. This is, however, an incomplete account of what went wrong. The bubble in credit and real estate would probably never have inflated but for well intentioned government interventions in the past. The current bubble which has caused so much pain recently may, itself, be an unintended consequence of past government interventions.

Specifically the Federal Reserve monopoly on setting interest rates and the Federal Reserve decision to pump tremendous liquidity into the economy in the wake of the dot com bust appears to have been the key enabler of the recent housing and income producing asset bubble. The government's decision, decades ago to intervene in housing market finance by creating and implicitly supporting Fannie Mae and Freddie Mac (though these agencies have also done a lot of good) also contributed to the bubble.

Once the initial interventions created the opportunity and incentives to inflate a massive bubble throughout the financial system, private financial institutions almost had to participate because game theory considerations make it almost impossible to ignore systemic incentives to act in a certain way. In these circumstances, private markets tend to take things to excess – with devastating follow on consequences to themselves and the economy too.

As we've described before, the current monetary interventions are likely to succeed in reviving the economy, and probably sooner than people currently expect. Massive monetary stimulus is going to work. There is a good chance it will start to work prior to the end of 2009, but if not then in 2010. When the growing monetary and fiscal stimulus measures finally take root, economic activity will normalize and then begin to accelerate again and the market will turn up even earlier.

Unfortunately, just as in the past, there will be many unintended consequences of today's short-term policy decisions. Some of the most likely implications include a significant increase in inflation (just not right away) and a significant fall in the value of the dollar. One new bubble that has already been fueled by recent developments may be in the treasury market, where long-term treasury yields had fallen (and recently retraced a bit) to levels at which they offer close to negative real rates of return in all but a deflationary environment. The treasury bubble, when it bursts, will probably be very painful and could have implications for the borrowing ability of the U.S. government and the status of the US dollar as well.

Our Plan for 2009 and Beyond

Stocks and bonds are now very attractively valued - the entire stock market is worth less than 75% of the current US GDP, a level which is only infrequently reached. Unfortunately, it can still go lower as a percentage of GDP as it has a few times in the past (always temporarily). At current levels, investors can purchase an interest in all the assets and the entire future productive capacity of the public companies in the US economy for three-fourths of the output of the economy *in a single year*.

Low valuations are a positive indicator because the most important consideration for future returns (in the long-term) is current valuations. Price and long-term return are always inversely related. The lower the price of the stock market the higher will be its expected long-term return and vice versa. Current prices are lower than average, so from current prices, we long-term investors should enjoy a much better than average return. *How good* and *when* are still unknown.

Ironically, just as the expected return (also called the risk premium for taking investment risk) rises - your gut tells you that the opposite is happening. So after prices fall severely, most investors feel very uncomfortable and either don't want to invest or want to cash out past investments made, even though the expected return has gone up. Similarly after prices rise in a bull market, most investors do want to invest even though the expected return has actually gone down and may even be negative.

If you are feeling nervous or uncomfortable right now, remember that almost everyone feels this way in a bear market, and that a significant amount of the pain associated with being a long-term investor has already been suffered up to this point in the current bear market. The market is like a roller coaster and people who panic during bear markets are enjoying only the downside without sticking around for the upside that we *know* is coming.

The majority of investments that we have made for ourselves and our clients may have declined in price (though less than the market), but you should think of most of these declines as *temporary*. While these prices are certainly “real”, investors who have not purchased their investments on margin are not forced to sell. We can choose to ignore current market prices when they are too low as they are now.

Economic growth is a long-term secular trend that is only interrupted occasionally and generally for short periods of time. Even in 2008, the overall GDP actually still grew. The economy is forecasted to shrink a few percent in 2009 and part of 2010. However, it continues to be highly likely that the economy will resume economic growth. Despite a massive asset bubble and some misallocation of resources over the last decade, all the excess houses and machinery, and much of the innovation that occurred did not disappear. As a society, we are still rich and mostly have and can enjoy most of the same stuff we did a year or two ago (prior to the bear market). What has changed is how people currently feel and also their behavior. Right now they don’t feel confident, for a variety of good reasons, so they are acting accordingly.

Since we have high confidence that our markets will recover (though not necessarily in the next 12 to 18 months), we are therefore spending the majority of our time thinking about which investments and opportunities (if they're not already in our portfolio) may benefit most significantly from the market recovery that we believe is inevitable while also limiting our risk of permanent loss in the interim. This is challenging (in a good way), because given the events of the last six months, a very wide choice of investments are available today at prices that we've never seen in our lifetimes. Choosing among these many investments is not a trivial job, but that is the task that we are pursuing.

It is likely that the greatest opportunities in the long run will come from sectors that are today the most unloved (and have declined the most). As between equities and bonds, there are excellent opportunities in both areas (in the latter for the first time in a while when judged from a valuation and yield perspective). Among companies and investments, we are focusing on entities whose survival is not based on relatively continuous access to capital markets and who are conservatively financed.

We are optimistic that long-term returns from here ought to be far better than the last 10 years, because the combination of low valuations, low interest rates, the self-healing nature of the economy, the monetary and fiscal stimulus, and the likelihood of a resumption of economic growth, is a powerful foundation for returns to be much higher going forward. The tremendous amount of cash that will eventually re-enter the market and drive the market upward is another key consideration.

As a reminder, our long-term optimism should not be taken as a forecast on the near term prospects for the market in 2009, or even 2010, which if anything are probably still negative. Whether or not it turns out to be as bad as some are currently still predicting, we remain highly confident of the ability of markets in general, and our value portfolios specifically, to generate worthwhile overall returns for our investors in time.

Someone once noted that investors, eventually, get the returns that they *deserve*. Along these same lines, Bernard Baruch, late in his life, noted that “During my eighty-seven years, I have witnessed a whole succession of [innovations, revolutions, and changes] . . . But none of them has done away with the need for character in the individual or the ability to think.” It is during difficult times like these that investors have the greatest opportunity to both develop their character and thinking ability and demonstrate the patience and equanimity that are the foundation of *deserving* long-term investment success.

We welcome your questions and comments, and thank you for continuing to allow us to assist you and your families navigate this difficult and trying period in the investment markets.

Sincerely,

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Kaushal “Ken” Majmudar