The Art of Intelligent Investing℠

Letter to Clients

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We have not written or distributed one of our letters in some time because the body of our existing letters (which are available on our website at www.ridgewoodgrp.com) already do a good job of explaining our approach and philosophy in a fairly comprehensive manner – and this was the original reason we started writing the six previous letters already available on our website.

However, given the negative market in the last several months including in the first few weeks of 2008 and the impact that market turmoil has had on our portfolios, we are writing to discuss the factors behind the current market environment, how it might affect our investments, and relevant lessons from other challenging market environments and recessions that will hopefully help you understand what is happening and what impact it might have on us in the near term (perhaps significant) and the long-term (not much – could even be a net positive).

Before doing so, we would like to thank you for being a client, trusting us to manage some or all of your money, and for staying patient and focused on the long-term. Despite bad markets of late, try not to buy into panic or fear – especially if your goal is to obtain good long-term investment gains. I thank several of you for realizing, on your own, that market declines usually create attractive buying opportunities and calling or emailing us to say that you plan on adding cash to your accounts opportunistically.

At this point, before going into our discussion of the environment for investing, a caveat is appropriate: we do not know what the immediate future holds. Give the complexity of markets, our crystal ball is always, at best, quite hazy. I offer predictions with hesitation (We agree with Warren Buffett that "forecasts about the future often tell you more about the forecaster than about the future.").

Still, as a client, it is reasonable for you to ask us what we think – so we will do our best to answer clearly and candidly. In this regard, I will apologize in advance for a rather lengthy letter. There is much going on at present, and the current combination of factors is unique in certain respects, at least in recent times. The interrelationships are complex and worth exploring in detail.

For those of you who may just want the bottom line, here is a preview: The issues around credit and real estate are real and worrisome but will be overcome in time. By now, a certain amount of it is already discounted in stock prices that have fallen in recent months, but there may be more to come. We are partway through a process that was somewhat overdue – i.e. the unwinding of a substantial housing/credit bubble formed starting in 2004. Despite this issue there are still a number of reasons to be optimistic in the long-run about both the US and the global economy – and our investments. If investor psychology stays negative or becomes even more negative, there will probably be some panic selling by market participants that will temporarily depress market valuations and most of the securities in it – including some of our investments. If this is the start of a bear period of the market, again no way to tell except in hindsight, things could stay volatile. However, a number of factors we discuss at the end of this letter suggest that we will get through any difficult period that may be ahead.

Review of Recent Market Performance

Long-term investors know that in any short-term stretch of years (think one, two, or three year periods), the market can rise and fall unpredictably. There is a certain chaotic seasonality to returns. Over the long haul, approximately one out of every four years will be negative. Despite this, equities should still outperform bonds over long time frames.

As we speak, and including 2007, we have not had a down year in the US markets, in nominal terms, since 2002. Though current valuations are not particularly stretched, it is not unreasonable to think that we might be overdue for a negative year or two (but this is not a certainty). On occasion, the market can fall for 2 years in a row – three years in a row is quite rare (though it has happened). Even if we do have a negative year or two, it usually bounces back – especially when valuations are already attractive or at least not frothy to begin with.

As measured by the S&P 500 index (excluding dividends), the recent market peak occurred on October 9, 2007 when the index reached 1565.15 (this compares to an index value at December 31, 2006 of 1418.3). From that point, the 4th Quarter was mostly down, and the index ended the year on Dec 31, 2007 at the level of 1468.36, down 6.18% between Oct 9th and year end (Still up 3.53% - not counting dividends – for 2007). Through January 17th, 2008, the index reached a level of 1325.19 – a further decline of 9.75% in just the first 13 trading days of 2008. The total decline since Oct 9th 2007 has been 15.3%. This decline brought the index back around its value in early October 2006 – basically wiping out approximately the last 15 months of gains on the S&P 500.

The above snapshot captures just the S&P 500 overall. This index is dominated by large US companies. In this current sell off, and even over the last 1 year or so, smaller companies and value indexes have recently performed worse than the S&P 500. This same observation applies to value oriented index funds as well as many active value managers – both with good long-term track records. This has occurred, and may continue, despite value indexes and smaller company indexes performing significantly better than the S&P 500 over the very long-run (i.e. the majority of 10 year measurement periods).

The recent underperformance of small and value stocks is starting to occur after approximately 6 years of outperformance of these same indexes relative to the S&P 500. This period of outperformance started around 2000/2001. Prior to this, there was a period of underperformance in the small and value segments during a period in which large growth companies handily outperformed small and value and became very overvalued.

Even within the S&P 500 and markets in general, there has been a wide dispersion in the sources of returns. For example, financial stocks and anything related to consumer spending (such as retailers, auto makers) have fallen much more than the index (because they are directly affected by the credit adjustment we discuss below - financials were the worst performing sector in 2007 and early 2008 - both on a price action and earnings perspective). Meanwhile, sectors like energy and materials – commodity sectors that most value investors looking for quality businesses have often avoided or underweighted - actually did quite well (again) last year and for several years before that as well.

Since the S&P 500 contains all these companies and it is market cap weighted, it tends to have a more growth/anti-value orientation that is inherent in its index construction. Even more than the S&P 500, anything international – particularly emerging markets, and especially China and India, continued to increase in price for the third or fourth year in a row in 2007.

Valuations in these hot sectors and markets may be full, at least measured by historical standards, but the usual arguments about growth and different factors this time around are certainly being used to justify why India and China and materials are in a long-term bull market. It is not clear when this will change or whether investors are currently overlooking risks associated with the high flying markets and sectors.

The recent performance of the S&P 500 is somewhat atypical in another sense. More often than not, stocks have risen between mid-December and mid-January. Obviously, this was not the case in late 2007 and early 2008.

What to Do When Markets Are Dominated By Fear

Fear and bad news can affect the quoted prices of even good businesses – sometimes out of proportion with reality. Though other investors may be less willing to hold these investments, when their psychology or short-term prospects become negative, companies with sound fundamentals should do well over time.

History informs us that in an environment dominated by fear, good companies and investments are thrown out with the bad. Investors can panic and run. Ultimately, however, the difference is that quality investments made on a sound value-oriented basis usually come back to do well in the long-term.

Despite knowing this, it is hard not to be affected by the psychology of the market or to panic as quoted "losses" increase on a series of days or months. I would compare the current environment and what we can expect in the near term to a bout of severe turbulence on a flight. Those of you who are nervous fliers may appreciate the difference between hitting severe turbulence unannounced versus hitting the same turbulence after the captain has warned that we will be encountering turbulence, that it is likely to last for a certain period in duration, and that it will not lead to a crash of the aircraft. Continuing our analogy, the purpose of this letter is to tell you that we are likely to encounter continued turbulence in the markets, and that while it could end quickly, it could also last for several years as well.

As an investor, it is important to have the fortitude to stay grounded while others panic. Selling good investments in a panic is not the road to investment heaven. However, given the pain that can be involved in the short-term, it is hard to stay the course.

A great example of the need for and benefits of fortitude in sticking to sound investment decisions is illustrated by Mr. Buffett's original investment in the Washington Post Company. Buffett purchased Washington Post Stock for Berkshire Hathaway in 1973 (at a price that he estimated was a significant discount to its value at the time). While the business continued to do fine and build its value, the stock price showed a loss of around 25% by the end of 1974 as compared to the price Buffett paid for his stake in mid 1973 (i.e. his $10.6 million investment was "worth" only $8 million according to the market). Something that was already cheap became even cheaper.

That original stake is still a part of the Berkshire Hathaway portfolio 34 years later – he has not sold a share. Despite the initial 25% stock price decline, the stake purchased in 1973 is now worth $1.33 billion (a 126 fold return in 34 years – 15.28% compounded – excluding dividends). Of course, if Mr. Buffett could have bought at the very bottom, the return would have been 167 fold – but this is almost impossible to do. Even worse, if he had panicked because of the initial "quotational" loss on this $10.6 million investment – he would have missed out on the long-term benefit of his otherwise sound decision to make the original investment.

Quality in Our Current Portfolios is High but not Immune to Fear and Volatility

We have maintained cash and mostly a portfolio of high quality, value oriented, and in some cases, defensive holdings and value oriented enhanced index funds. Despite these facts, our holdings will still be affected by the overall market and poor investor psychology.

One of our holdings in core accounts is American Express. American Express is an exceptional business franchise. It has exceptional management, a wonderful brand, a large base of affluent customers, and higher margins than many other credit card companies. It also has a superior business model because most of the business is fee based and because the company makes fees both from consumers who use its credit cards as well as merchants on its closed loop payments network. Warren Buffet's Berkshire Hathaway is a large shareholder.

Despite these exceptional long-term merits, American Express has been sold-off recently due to worries about slowing consumer spending by its 52 million card members. In early December, American Express noticed that the rate of growth of spending across all consumers had slowed significantly (this is different than saying that there was an actual decline in spending – rather there was an increase, but just at a much slower rate). For this reason, the company announced that earnings growth might slow down in the near term. The long-term prospects for American Express are extremely bright, and this "defensive" financial services company will continue to be a holding for long-term investors.

Our largest holding also illustrates how prices in the short-term can be set by fear. By our own analysis, Berkshire Hathaway is, conservatively, worth above $5000 per B share. After a negative article in Barron's following a strong run-up in price (it seems momentum investors got into Berkshire for a short time this past fall), Berkshire recently corrected back to around 4300 per share.

The decline in Berkshire's stock price is ironic and represents an opportunity. It illustrates how other investors can behave irrationally and sell in a panic. In reality, and as we have written before, Berkshire is the ultimate defensive holding. In the next few years, it is highly likely that Berkshire will be investing its massive amount of cash (with more and more being generated each quarter), into many more exceptional businesses. If the overall market is very bad, Berkshire will have a tremendous amount of opportunity to make investments on very favorable terms. A recent increase in Buffet's investment activity in just the last month or two gives even more confidence to this thesis.

If the turbulence lasts, the next few years should be in Berkshire's sweet spot and we are happy owners at current levels – irrespective of market fluctuations. No matter the short-term price action, we can be confident that long-term value based investments in companies with high quality businesses like Berkshire and American Express, as well as our several turnaround investments, will do well over time. We have a number of other long-term holdings that we would group with these two great companies.

In 2007, our consumer facing companies – particularly our retailers (each of which is a turnaround situation) – have been particularly vulnerable to declines. Though each was purchased after significant drops, near term operating issues (characteristic of turnarounds) have continued to pressure their results and prices (as well as panicked investors running away from any company related to the consumer – probably overdoing it). Retailers have a fair amount of economic sensitivity and other investors are concerned about immediate earnings, not long-term value.

Fortunately, with few exceptions, each of our holdings in these areas has very little debt, solid management, and good prospects for recovery when their operating performance, investor psychology and/or the economic environment changes. The prices already discount very bad news, and there is much more upside than downside from current (we think oversold) levels in good retail companies.

Regarding deploying the substantial amounts of cash that we hold (it is our largest holding, and #2 currently is Berkshire), we remain cautious but will be opportunistic to take advantages of opportunities created by the markets.

For those accounts in which we utilize the high quality enhanced index funds, including the Dimensional strategies, these have also been affected and will continue to be affected by the recent trends away from value and small capitalization companies and the overall market declines in general. However, both the construction of these investment funds and their implementation is quite exceptional. By focusing on owning the "value" companies in the market, these funds have great long-term prospects. Though there will be volatility in returns and negative years when value is out of favor or the whole market is selling off, over time these investments should continue to do well.

The Credit Bubble Corrects

Let's review the factors and headlines causing fear:

- Housing market woes and subprime defaults and rising rate of home foreclosures
- Large write off from banks like Citigroup, Merrill Lynch, Bear Stearns, etc. and related cost cutting and layoffs
- Falling value of dollar
- Slow down in retail and consumer spending by US consumers
- Possibility that a recession has already started or is imminent
- Rising inflation in the form of commodities like gasoline, food, etc.

The current problems are being triggered by the unwinding of a fairly major credit bubble that started in 2004 and continued into 2007. Credit is, of course, created whenever an individual or institution borrows money (from an intermediary or investor). The expansion of credit is significant for an economy because credit is ultimately used to buy or create assets. The more credit in an economy, the more asset prices can rise as the demand and ability to pay for assets increases. Credit expansions have a self perpetuating quality because more credit means higher asset values and lower default rates – factors which, in turn, can be used to justify the extension of yet more credit.

This time around, existing and originally sound financial innovations like the repackaging of loans into pools that could be resold to investors went too far. People caught up in the credit bubble failed to do their homework. Poor underwriting, irresponsible risk taking, and abundant liquidity became the norm in a variety of asset classes. The liquidity created by this credit bubble went into all sorts of assets, from housing (both prime and subprime), to commercial real estate, to private equity, derivatives markets, hedge funds, and therefore also public equities (but to a much lesser extent in the case of the latter since absolute valuations are not that stretched).

There were many aspects of the credit bubble which were based on assumptions that were too good to be true. There is a saying that "If something can't go on forever – it won't." So while bad lending can look like it is working initially, anything with a poor basis in logic and good sense is destined to collapse eventually.

When any bubble deflates, there will be losses. Most affected will be the holders of the overvalued assets that were purchased on credit. This is why so many financial institutions and investment banks are announcing "losses" right now. They are the ones that in many cases originated the loans that were underwritten poorly based on faulty assumptions. Fortunately, they have now recognized that they made mistakes and the market and its participants are readjusting their expectations and actions. This process will take time. However, stock prices already anticipate a certain percentage of the further losses investors expect – generally the market will start to rally well before the fundamentals bottom completely and the recession, if it comes, is likely to end.

Still, there is further potential for additional negative news. This is likely because subprime loans were not the only ones made on a shaky foundation. While you may have read a lot about subprime loan write offs, there has not been much discussion of all the other types of loans made and not yet written off. There was also a lending bubble in commercial real estate and in private equity takeovers.

Most financial institutions also have massive highly leveraged balance sheets and derivative and hedge positions with significant "counterparty" exposure. If we are right about these other issues, financial institutions (not just in the US but also in Europe and in Asia), still have more issues to deal with as asset values continue to correct downward reflecting the significant reduction in the availability of "foolish" credit. Even sound projects and borrowers will be affected – at least for a time – and this will inevitably lead to some additional failures or write downs. Financial institutions are already pulling back their lending (mostly a healthy process because they are going to stop making as many poor loans).

Going forward, credit will have to be extended on more restrictive terms, and depressed asset values (especially real estate) will take its toll on balance sheets. Some assets will have to be repossessed and sold. Buyers may get deals, sellers and banks may take losses. As a result of the above factors, which are not huge surprises to anyone following the expansion of the credit bubble – it is reasonable to expect that the purging process may not be over yet. If so, then getting back to equilibrium will still involve more pain – but also create value and compelling buying opportunities along the way. Since the process is underway, it will eventually run its course and find a bottom.

Due to the unwinding of the credit bubble and its affect on asset prices, there is already a great deal of fear of a coming recession (defined by economic consensus as a 6 month or greater period in which economic activity contracts). Whether or not there is a recession is somewhat beside the point – we will not know until well after it officially begins.

The biggest issue on investors' minds is the health of the US consumer going forward. Tighter access to credit will probably affect consumer spending (it is not known for how long) and employment (though we are still near all time lows for unemployment). The reason for this worry is that US consumers drive approximately 70% of the US GDP. There is persuasive evidence that in early December, Americans – from working class to wealthy - began to cut back on personal consumption spending. American Express, which has a fairly robust window onto the velocity of global spending activity – almost in real time – noticed that consumers across the board – and especially in Florida and California – cut back on their spending. It is not known whether this slowdown is the beginning of a long-trend or just a short-term aberration.

A slow-down in consumer spending if prolonged would be important to the economy because it has broad effects. Due to these and other worries, Investors sold off equity securities across most segments, with the most significant selling pressure evident in areas like retail and financial services that directly touch on consumer spending and consumer confidence or are affected by the unwinding of the credit bubble. Lately, the selling activity has broadened. The timing of the slowdown was also bad from the point of view of retailers, since most retailers expect to make a significant portion of their annual sales during the busy holiday shopping season.

As discussed in our annual meeting, housing prices will probably continue to correct because they were unsustainable and disconnected from fundamental factors like incomes and demographics. There is a link between consumer spending and the housing market. Recent spending slowdowns have been greatest in areas like south Florida and California which were the biggest beneficiaries of the housing bubble and will be most affected by the unwinding of the bubble.

The unwinding of the bubble has not been that much of a surprise to us. Two years ago, I wrote an article in a New Jersey business magazine encouraging readers to recognize that there was a housing bubble going on. While noting that it would be impossible to predict when the bubble would pop, I recommended caution.

The biggest concern for the health of the US economy is uncertainty regarding how long the unwinding of the credit bubble will take. Banks and other investors who own the dubiously underwritten loans will likely endure more pain. A tightening of credit, which is already underway, will make consumers and businesses rethink their spending patterns. This is exactly the function of markets, and is a healthy process for the long-term viability of our economy, but it will also cause pain in the beginning – particularly to those who laid their plans assuming that easy credit would continue to be cheap and plentiful. As discussed later, Fed easing of interest rates will start to help and be a major catalyst in the healing process.

Investor Psychology is a Big Determinant of Short Term Security Prices

Sometimes, investors are extremely optimistic and/or complacent and they bid prices up, manically. At other times, like the present, they become fearful and depressive – adopting the policy of selling securities regardless of fundamentals. During bouts of fear, the mantra becomes to sell first and ask questions later.

Of course, the selling usually has some basis in logic – investors and many institutions, like hedge funds, tend to be very focused on price momentum and short-term earnings growth. As a result, when earnings expectations become more uncertain or become negative, prices can fall hard. This happens even though the value of a company is based on its long-term cash flow, and a decline in earnings for the first year or two of a ten year period often does not have a very significant impact on the long-term cash flows or intrinsic value of an otherwise sound business.

As a general concept, and for anyone with a 5 to 10 year investment horizon, it does not pay to buy into or be overly swayed by bouts of fear and panic – even if it seems justified. Selling everything and moving 100% into cash might work for a while, but would also lead to a high chance that the investor would miss the inevitable and unpredictable market recovery or rally when it arrives.

Since we do not know when this will occur, it is better to make adjustments, but basically hold onto our investments if they have sound prospects for the long-term (which we believe they do). Assuming, for the moment, that the next few quarters (or years) continue to be bad (and this is by no means a certainty), the worst thing for a long-term investor to do is to capitulate, especially at or near a bottom. However, most investors (though they call themselves long-term) – have a much lower threshold for "pain" than they usually admit. This is why investors can initially be patient, but by the time they are well into any real bear market – they eventually lose patience – or become very fearful. When the majority of investors, finally, capitulate, the bear market is probably over.

The market is a discounting mechanism and today's prices already reflect the consensus view of the future. If most people are concerned about a recession, it is generally already reflected in prices. To make money trading based on your views of the economy is very difficult because you have to be able to predict things that others do not already know or anticipate, and do so on a consistent basis over time. Long-term investors on the other hand manage to make money, despite the occasional bear market along the way and they do not have to make many predictions – just pay attention to value and invest in sound companies or strategies. Looking around, it is easy to identify many wealthy long-term and value investors. On the other hand, it is difficult to identify many traders who get rich from investing or trading their way to success.

Reasons to be Optimistic about the Long-term

Despite the above mentioned risks related to credit driven readjustments, we believe there are many reasons to be optimistic in the intermediate to long-term (i.e. the next 5 to 10 years). These reasons include:

- An open and dynamic US economy that has had a track record of flexibility
- Global growth driven especially by the ongoing development of counties in Asia and Latin America
- The near certainty that the Fed will continue to take swift actions to fight deflationary forces with significant interest rate cuts and/or liquidity injections in the near future
- Valuations which are not stretched in most cases, even though short-term earnings may be vulnerable
- Lots of global liquidity as evidenced by money held by foreign sovereigns – money that can eventually invest in the US markets and elsewhere

The most important item on the above list for the long-term is that the US has a flexible economy that is both capable of and likely to make the necessary adjustments in a post-credit bubble economy. This flexibility is important because it means that we will collectively take steps to address past issues and ultimately move on.

In the near term, the two most important items on the above list are related to the likely impact of Fed action and the absolute level of valuations in the US. While there are things to worry about (there always are), there is evidence that there is a strong relationship between Federal Reserve interest rate policy and stock returns. Specifically, in periods after the Federal Reserve starts lowering the discount rate charged to banks, stock market returns soar. However, in most cases, it takes approximately one year before they start working their magic on stock market returns. Starting in August 2007, the Federal Reserve began easing the discount rate, so if the historical experience is applicable, there should be some impact in the latter half of 2008. It is likely that at the next meeting of the Fed (or before), they will announce an easing of the discount rate by 50 or possibly even 75 basis points.

Lower interest rates will also be a boon to financial institutions, especially banks. They will use the spread between lower short term rates and their higher earning long-term assets to rebuild their capital positions and balance sheets over the next few years. Along with the new capital infusions they have received, they will be able to continue making loans to credit worthy borrowers. This dynamic of lower interest rates and a work out of problem assets was a big reason why financial institutions ended up surviving and ultimately thriving in the last significant credit/real estate contraction in the early 1990s.

In addition, it is important examine the absolute level of valuations, especially in comparison to interest rates. On this front also, the news is not discouraging. Especially in light of the recent market declines, and assuming some short term earnings hits from financial sector write downs, the S&P 500 is trading at a forward PE of approximately 15x. In light of the 10 year bond which currently trades at 3.65%, this valuation is very reasonable – even attractive. The low 10 year bond rate reflects some technical factors, like money moving to the sidelines reflecting fear and/or panic. However, it is also testament to the fact that the world still remains awash in liquidity - liquidity that will eventually find its way back into quality investments including individual companies and market wide portfolios.

Even if we are or will soon be in a recession, history tells us that these periods of turbulence/adjustment generally do not last very long (for example, the average recession in the US has tended to last between 6 to 18 months). This is not the first time that the US will be experiencing a credit crunch and housing slow down. The last significant period was in the early 1990s. At that time, there was also a relatively brief recession. However, stock prices did not stay down long and ultimately recovered in anticipation of the recovery. As we work though the current issues, a similar pattern is likely, the economy and markets may fall, but should recover within a few years.

Meanwhile, there will be a number of attractive opportunities created by fear and panic. To find the most fertile hunting grounds for these investments, you need only to ask which areas are most hated. Some of the best performing investments you could have made during the early

1990s recession were financial services companies and distressed assets generally. Companies like Wells Fargo, Mellon Bank, and others that were undergoing write-downs and earnings hits ended up being multi-baggers, especially from those depressed levels.

Of course, there are many doom and gloom headlines right now. Stock markets in the US, Europe and Asia have lately been declining more consistently than is normal. Perhaps this time is different, and maybe a downturn could be longer than average. However, with an active Fed and perhaps fiscal intervention, as well as market based actions, we will get past the current issues – much as we have the many other recessions/bubbles in the past. As this process unfolds, certain investors (mostly the ones holding the bad loans or speculative assets) will lose. Others will be affected temporarily, but will eventually recover and go on to new heights. Some will even profit mightily by buying cheap assets when they are being liquidated by others who are overcome by panic or forced to do so by liquidity needs.

Despite the recent issues and challenges, we will continue to work on your behalf to identify attractively priced investments and look for opportunities to position our portfolios in value investments that will helps us participate in the ultimately recovery, though it may take some time and involve some discomfort on the way there.

As always, we continue to welcome your support, questions, comments and suggestions. Please continue to visit and tell your friends about our website at www.ridgewoodgrp.com, and our blog at www.ridgewoodgrp.com/blog. We look forward to working with you during the balance of 2008 and beyond!

Warm Regards,

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The Ridgewood Group is a value oriented money management firm based in Short Hills, NJ. For more information on The Ridgewood Group and our approach to intelligent value oriented investing, please visit our website at www.ridgewoodgrp.com.

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