September 15, 2008

Dear Valued Clients and Friends,

Some of you may be alarmed reading the headlines this morning about Lehman Brother's Chapter 11 filing and the sale of Merrill Lynch to Bank of America. Especially so since these announcements follow the recent Government actions with respect to Fannie Mae and Freddie Mac and the other news that AIG needs to raise more capital.

It has been interesting reading these articles and the news coverage associated with these events. Much of the coverage demonstrates only a partial understanding of the underlying causes and implications of these events. We have prepared this update offering some perspectives on the headlines and how we are thinking about the effect of these developments on our portfolios.

The underlying cause of all these events can be traced to one basic culprit. A number of financial institutions in the US, and even globally, made ill advised commitments over the last 3 to 5 years to assets that were poorly underwritten (mostly securitized fractional interests in pools of residential and commercial loans). Underwriting is a basic function of any financial company (the essence of what they are supposed to do well). In a nutshell, underwriting involves making judgments about whether a particular asset or customer deserves to be funded, and if so at what price. Rule 101 of sound underwriting is to think about the likelihood that this asset or customer will be able to return the initial capital invested or loaned under a variety of likely scenarios. After clearing this initial hurdle, the underwriter must make sure to also charge enough to make an adequate return on the capital committed.

The speed with which these companies (and others including Bear Stearns) went from being considered by the market as basically sound underwriters to admitting that they had underwritten poorly was accelerated by the way that they funded their poorly underwritten commitments. In particular, investment banks have used a large amount of short-term loans to fund their longer-term assets.

This model was and is flawed because it cannot withstand any crisis of confidence. Specifically, all the investment banks borrow a lot of short-term money (often overnight) in order to buy or fund a lot of longer term assets. Unlike savings banks that have FDIC insured depositors who tend to stick around, investment banks have no sticky deposits, they mostly borrow the money they need to keep going by refinancing it each time it is due. As we see with Lehman today and Bear Stearns earlier this year, this approach is very vulnerable to failure.

When lenders to Lehman began to realize that they had made loans against assets that were not worth what they should have been (due to the above bad underwriting), it was a swift process for investors to lose confidence and insist that they did not wish to renew these short term loans that keep the process going.

This explains why Lehman Brothers filed for Chapter 11 bankruptcy protection today – their lenders wanted their money back, but their assets were not worth as much as Lehman once thought and in any case they could not be turned into cash in time to pay off the lenders. By filing for Chapter 11, Lehman Brothers gets an "automatic stay" against its creditors/lenders. Lenders are prohibited from demanding repayment of their loans and claims. Instead, they now have to go to the courthouse, register each loan or claim and then wait for whatever repayment or resolution is ultimately decided upon through the bankruptcy process.

Repayment in bankruptcy follows seniority of claims. Secured bank loans get paid first, then senior loans, then subordinated loans, next preferred stock holders and finally equity holders are last. Though we don't know today what Lehman's assets will ultimately be worth when they are sold, repaid, or restructured, we know that it will not be enough for equity holders in the company to get anything, preferred holders will probably also lose all their money and subordinated holders and senior holders will probably suffer varying degrees of impairment.

Beside all the public stock holders, employees of Lehman owned 25% of the firm, worth about $10 billion or more less than a year ago. This stake is now worthless – and will no doubt affect both their sense of financial security and consumption patterns. Though Lehman has a number of sound businesses and assets, most of which will be sold or restructured, the firm in the aggregate owed more than it had which lead it to file for bankruptcy this morning. To the extent that a firm or investor is desperate and needs to raise cash by selling its assets very quickly, it can lead to greater losses on those asset sales than if the holder had time to sell them patiently. A Chapter 11 filing gives Lehman Brothers time to conduct an orderly disposition or restructuring of its assets and liabilities – this is the purpose of Chapter 11 bankruptcy reorganization.

If you read the press release, you will notice that Lehman Brothers Holdings filed for protection under Chapter 11. Some of its operating divisions, like the Broker/Dealer subsidiary and Neuberger Berman

LLC were not included in the filing. These operating businesses are assets that will probably be sold in the process.

Since a few clients have asked the question, it is important to understand that client brokerage accounts and in the case of AIG – insurance policies or annuities with the operating or insurance businesses of the company - typically are segregated assets that are protected in regulated subsidiaries. As such, a brokerage account client or annuity/life insurance policy holder would not be affected by the filings or distress of the parent company except in rare circumstances. The main losers will be equity holders and/or lenders to the companies involved.

Why did so many supposedly sophisticated institutions, including Lehman Brothers which has a 158 year history in business engage in bad underwriting? The basic reason comes down to a combination of not being cautious enough, partly related to misaligned incentives, and following the herd without critically questioning whether it would make long-term sense to do so. In particular, in most of these institutions, employees are compensated based on the "profits" they helped generate in a single calendar year.

Although a reasonable person could foresee that certain activities and investments that these investment banks were aggressively courting in the last five years entailed greater risk, few were looking critically at the long-term risks associated with these activities because they were working. Risk taking that will definitely work for 2 to 4 years leads to higher compensation for the managers and employees than being prudent and conservative. Moreover, when everyone is doing something and making money at it, it is virtually impossible to swim against the tide. In asset prices, the herd has a self fulfilling influence. Whatever the herd is investing in will increase in price – sometimes for quite a while. In these types of environments, it is the most aggressive and risk taking managers and employees who get all the rewards – the conservative voices of reason are either paid less or fired for not "getting it."

AIG's issue is a little different, though ultimately it still comes down to bad underwriting. In particular, AIG – one of the world's largest insurance companies – has a division that wrote credit insurance on debt that others had issued. Fannie Mae and Freddie Mac also issued these financial guarantees. Effectively, AIG and Fannie and Freddie promised a variety of their customers that if they experienced any losses on their holdings of certain bonds issued against mortgages and other securities, they would make up the losses. It turns out that the losses are going to be much greater than the guarantors anticipated or charged for, so they are on the hook for large payments under these guarantees. Again, while foreseeable, this miscalculation was based on a flawed statistical argument that almost everyone bought into at the time.

So in essence, the ongoing "financial crisis" can also be considered a recalibration of underwriting assumptions and expectations. Risks that were assessed as being artificially too low are being revised upward. Assets which probably should never have been created and were represented as being worth too much are being written down or written off. As this process continues, and even now, loans will be harder to secure for both individuals and companies and institutions will have to be restructured. Ultimately this process is healthy for our economy and country and leads to more rational and better allocation of our human and capital resources, but obviously it leads to pain and dislocation in many sectors. It is because of the latter impacts, that the Federal Government and the Federal Reserve Bank are doing whatever they can to cushion the blow of these failures by "socializing" a certain amount of losses, spreading them from particular lenders/investors to taxpayers at large.

In our portfolios, which are basically value oriented, we don't have any direct investments in any of these companies above. The vast majority of our investments are in companies that are conservatively financed and run by capable managers. Although many value investors invested in banks and investment banking financial companies on the way down, we did not make this mistake, **mainly because we thought they lacked the safety that we look for in our investments.**

Although the direct effects on our investments have been limited, the stock market as a whole is being marked down through a combination of reduced earnings expectations and tightening liquidity (both good and valid reasons for stocks to fall) as well as fear and panic (which can often be overdone). All these events will likely continue to put pressure on jobs and economic activity for some time – typically recessions last 12 to 18 months and this time it could be worse than average. We don't see any reasons that things should improve quickly.

Despite the above observations, the stock market is a discounting mechanism with many complex inter-relationships that make forecasts of market direction an exercise in futility. Though the market could fall further, perhaps even significantly, in the next 12 to 24 months, we do not think it makes sense to sell good long-term investments or to hold back from making new investments in good opportunities created by this market. We have cash to invest, and it is likely that we will be net buyers in this environment.

Our country and markets have always recovered from crises. It is prudent to act on the assumption that this time will be no different. When it does recover, the market will move up quickly and missing that move could ultimately be quite costly. However, we don't know when that will happen (and we can't even be 100% sure that it will – though it is very very likely). Until then, you have to be prepared psychologically and constitutionally to ride out volatility.

If you can't do this, and some will not be able to, please let us know. Though we hate to sell good long-term investments into a poor market, it may be the best alternative for those who cannot wait it out without losing sleep. There are some alternatives to equities that are being created by the market in that some relatively secure bonds with a maturity of 3 to 6 years are offering yield in the 6.5 to 8% range and may be decent alternatives to equities for some investors.

However, if you can afford to be patient and are willing to do so, we believe that the announcements today should be taken in stride. Long-term value investors will, we believe, continue to enjoy reasonable results when viewed through the prism of a sufficiently long investment horizon. After we go through this current period (of uncertain duration), it is still a good bet that American and Global businesses, particularly if they are purchased at value prices, will continue to create tremendous wealth for their owners, as they have done in the past.

Sincerely,

Ahalya   Kaushal

Ahalya Nava   Kaushal "Ken" Majmudar