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Third Quarter Commentary

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I've seen the future, brother:
it is murder.
Things are going to slide, slide in all directions
Won't be nothing
Nothing you can measure anymore
Leonard Cohen, The Future

The financial world is virtually locked in a state of paralysis. Regulators, policymakers and elected officials have moved too slowly to address the problems in the credit markets and consequently they now find themselves dangerously behind the curve. Events are unfolding out of control and at times are seemingly headed towards a financial meltdown. After a lengthy period of outperformance, our portfolios underperformed this quarter bringing our year to date returns largely in line with major market indices. Factors driving our stocks lower include fear of an extreme global economic slowdown, fund liquidations and redemptions, margin calls, a heightened demand for US dollars and a lack of visible near-term catalysts. Of these, I think that the fear factor has been the dominant problem.

Index Performance	3Q	YTD
DJIA w/divs.	-3.72%	-16.60%
S&P 500 w/divs.	-8.50	-19.40
Nasdaq Comp w/divs.	-9.19	-21.49

In situations like this it is easy to be caught up in the general amorphous fear and make panicked decisions that we may regret days or weeks later. Instead of rumors, guesses and opinion presented as facts, we need to focus on solid information and ask questions rather than jump to conclusions. I strongly believe that when we are surrounded by panic the less we do the better. As in medicine, the first goal is to do no harm. Where we can, we seek to improve our position. Late in the quarter we made a decision out of an abundance of caution to move cash from money markets to direct ownership of short-term Treasury bills as explained already in a separate letter.

In some respects this feels like the financial equivalent of 9/11. For a brief period on that tragic day, no one knew how many more hits would come and where. Huge selloffs have been followed by equally huge rallies playing havoc with our emotions. It is impossible not to be affected. In this environment it can seem like nothing you know is true anymore. Why are seemingly unrelated assets being sold – dumped

really- at fire sale prices? Why has the dollar strengthened since August? Why has gold not taken off? Why did the financial services component of the S&P 500 outperform the broad market during the quarter?

There is no doubt anymore that this is the worst financial crisis of our lives. Unlike other financial events of recent years that stemmed from problems in a particular region or firm, this is a systemic crisis. Although at the outset last year it was regarded as a problem with subprime mortgages that affected a relatively small set of irresponsible lenders and borrowers, we can see now that this is not just a matter of a few "bad apples".

The initial trigger for the problem appears to have been the decreasing affordability of home loans for the most vulnerable people caught in the squeeze of rising costs for medical expenses, food, and fuel and declining real wages. The same squeeze that began to force people to sell their homes also removed millions of people from the potential pool of buyers. As home values fell, the default and foreclosure rates began to rise well above levels envisioned by the architects of modern finance. This eventually set off alarms among the buyers of sliced and diced mortgage spam. Much of this loan span is "insured" for credit risk. This proved to be an especially bad idea for both the sellers of such insurance and the buyers who found that the insurance is worthless if your counterparty cannot keep up their end of the deal. The concept of using credit default insurance is somewhat reminiscent of the ill-conceived notion of portfolio insurance that fueled the 1987 crash. The lesson perhaps is that sophisticated financial modeling can provide false security. Insurance is not a substitute for understanding, accepting and being properly *compensated* for the risks of an investment. Because the risks were perceived to be so low, Wall Street decided that it could cut loan-loss reserves, lever up and goose returns. The computer models broke down both because of bad data (falsified income statements and inflated appraisals) and because of a failure to account for the systemic risks in the economy (especially higher energy prices in the *absence* of a stronger economy). So now we have a levered-up interconnected mess that to most people seems to bear no relationship to the underlying problem of the declining affordability of the American middle class dream.

Layered on top of the aforementioned train wreck is the additional problem that the bankers no longer trust *each other*. This is attested to by the gulf that has opened up between T-bills and LIBOR or the rate at which bankers are willing to lend to other bankers. And if bankers can't borrow money, very suddenly triple A rated GE can't borrow short-term, California can't borrow to fund daily operations and neighborhood businesses can't borrow to finance inventory and their customers can't borrow to finance purchases.

So while we are watching the titans of the financial world struggle to survive in a fight against insolvency that has already claimed Bear Stearns, Lehman Bros, Merrill Lynch, Fannie Mae, Freddie Mac, AIG, Washington Mutual and Wachovia, the great fear is that this crisis will spread to the broader economy (Main Street in political parlance) leading to a Great Depression. Although I have suggested in the past that I believe that Peak Oil and the failure to take early action to mitigate its effects could lead to the worst and most prolonged economic decline since the Industrial Revolution, I don't think that we are there yet: oil is still too cheap. In my view the rising cost of producing oil has played a role in the current disaster but its effect has been greatly magnified by excessive leverage in the system, regulatory and policy failure, and the resulting fear and distrust. In my opinion the current crisis will be salvaged by the most massive global infusions of government credit. Until the recent collapse of commodity prices to merely very high from all-time-record-high-and-only-going-higher, inflation worries restrained some policymakers from acting more decisively and perhaps kept Ben Bernanke's helicopters grounded. (For an explanation, Google Helicopter Ben). I think that the combination of heightened alarm over the potential for a catastrophic breakdown and the belief that a slower economy will restrain commodity prices, will now permit truly massive intervention in the markets. This action will, inevitably, result in inflation, or stated differently the debasement of paper currency. However distasteful this might be, it is the only politically acceptable way out of the current predicament. The alternative can only be a deflationary depression that given the enormous disparity in wealth could even lead to a partial breakdown of society: street riots, rising crime rates, including more violent robbery, kidnappings, and murder- Leonard Cohen's warning of the future.

Before closing, I would like to highlight some fundamentals that will matter once fundamentals matter again. From an operational standpoint, the companies that we hold, almost without exception, have strong

balance sheets and good cash flows. In the energy sector in particular, business conditions remain extremely robust and even this week there is continued newsflow indicating very strong oilfield activity. For instance in the North American jackup market there were twelve new contracts signed last week, ten of which were signed at higher rates than the current rates at which the rigs are working. In the past month several deepwater rig contracts were signed at record dayrates. The deepwater market is "virtually sold out for the rest of 2008 and all of 2009" according to a recent Citigroup report that goes on to state that companies are "booking rig time for 2011 and 2012 because they know that six months from now little or no un-contracted rig time may remain in those years."

Sometimes it almost seems as if these companies inhabit a different world than their stock prices, however I want to caution that if the recession becomes deep enough on a global basis, the decline in oil consumption may outstrip the decline in production that is almost certainly coming and this could lead to oil prices under $60. Under these circumstances we could see rig utilization and dayrates fall significantly. This is the scenario that the market appears to be pricing into energy stocks. Although this "Sum of All Fears" has taken hold, I believe that it is an unlikely possibility for several reasons. First we have to consider the mature state of the oil fields supplying us today. Accelerating decline rates require ever increasing investment simply to stand still and maintain production. The IEA and oil industry executives continue to say that we are simply not investing enough to find and produce the oil we will need in the future. A chronic shortage of experienced personnel, drilling rigs and other equipment, coupled with the increasing complexity of developing new oilfields in deep water and harsh environments is leading to long delays and large cost overruns in bringing new production on-stream. To these issues we must now add greater difficulty in accessing the capital markets and more uncertainty about future oil prices. The increased cost of capital feeds through into higher costs to produce crude. Some new conventional oil projects require $75 or $80 per barrel to be worthwhile. New oil sands development is no longer economically viable under $100 per barrel and as a result we are already seeing some oil sands and other non-conventional oil projects get pushed out or canceled. Bottom line: $60 oil is as unlikely to be sustainable as $147 was this past July.

At a recent meeting with analysts and investors, the Chairman and CEO of Schlumberger, Andrew Gould, spoke about the 1998-1999 period when they fired 12,000 people because experts were saying in April (1999) that oil prices were going to stay at $10 for the foreseeable future. By August oil was $25 and nine years later it had increased almost 15 fold. This time they are making up their own minds at Schlumberger, watching the reservoirs on which they work instead of listening to economists.

This year has turned out far more difficult than even those of us who were worried about the debt-driven excesses ever expected. Clearly I would have done things differently had I known some of what I know now in June. It is not the nature or even the size of the credit problem that I find surprising, but the lack of effective policy response. I expected such severe problems to be met with an equally enormous globally coordinated policy response. It is shocking to me that the world's Central Bankers would allow the situation to get this close to the brink, but I believe that having stared into the abyss they are now starting to act decisively. Although our strategy has led to very disappointing results this quarter, we have avoided the worst of the carnage, our cash level has been boosted by the Xantrex buyout that closed just after the end of the quarter, and I believe that in the coming reflation, we are poised to outperform once again.

M.S.