



A WISE MAN ONCE SAID that markets will do whatever it takes to confound the vast majority of investors at all times. So far this year, this concept has demonstrated its truth.

We understand and empathize with the frustrations of equity investors as portfolios have suffered declines for the year. Almost every sector has been adversely affected, though not at the same time. While the general U.S. market declined earlier this year, our equity portfolios experienced most of their losses this quarter. But if tempted to retreat from risk, one must understand what has happened and why, and what opportunities this can bring going forward.

On July 13th, the Fed, Treasury, and SEC simultaneously embarked on an intervention of surreal scope, sparking a staggering rally in the U.S. dollar (see *graph below*) and triggering this summer's sell-off in foreign stocks, commodities, and non-dollar bonds. This Sunday-announced intercession caused a massive liquidity squeeze on leveraged investors because their short positions (which are liabilities) rose dramatically and rolling over their funding was becoming increasingly expensive. These investors were essentially forced to fire-sale assets to raise the cash needed to meet margin calls and to pay back the banks and brokers.

Why did the intervention occur?

Earlier this summer, it became increasingly clear to Treasury Secretary Hank Paulson and Fed Chief Ben Bernanke that the financial system was heading towards its biggest crisis since 1929. Banks were shackled to a drowning U.S. real estate market through increasingly low-quality loans and derivatives. To make matters worse, inflationary pressures accelerated as commodity prices reached new highs because of strong demand overseas from emerging economies. Food shortages were also pressuring wages globally.

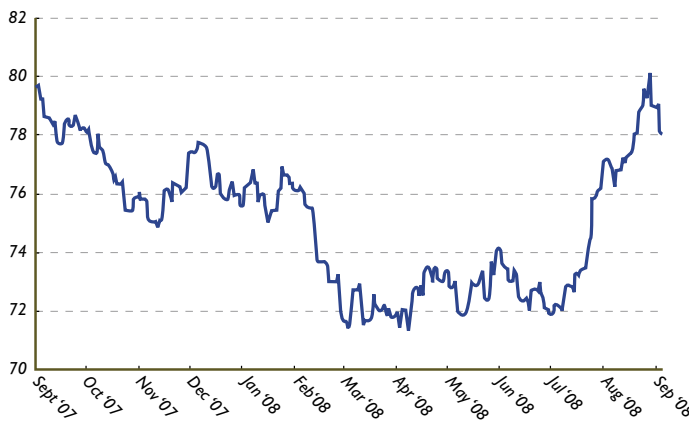
This inflation further squeezed U.S. consumers, making the loans on banks' balance sheets all the more dubious (because the odds of being paid back became more risky). And, the Bank Stock Index had plunged from 90 to 50 in six months and all recent equity infusions from Sovereign Wealth Funds (e.g., Kuwait's and Singapore's \$12.5 billion investment in Citigroup) were significantly underwater. Finally, Fannie Mae and Freddie Mac (F&F) were on the edge of collapse, with hundreds of billions' worth of their debt held by government funds abroad. International investors anxiously questioned the U.S. Treasury's willingness to make good on its unspoken promise to back F&F's obligations.

What to do?

Answer: relieve the strain on the heavily-levered banks by putting pressure on the heavily-levered speculators and hedge funds. "Speculation," by the way, was the oft-

U.S. Dollar Index: September 15, 2007–September 18, 2008

Source: Bloomberg



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ASSET MANAGEMENT COMPANY

“*It is our job to appraise the long-term risks and opportunities and to have other investors’ irrationality and short-term orientation working in our favor.*”



New Bear-market Pickup Line



“Yeah, well, actually, I’m down just 10%.”

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cited root cause of rising inflation this year—not supply/demand imbalances, declining U.S. credit market health or a slowing U.S. economy—and a solution to remove this stress was badly needed. Never mind that the “speculators” in commodities are the likes of Calpers, TIAA-CREF, Taft-Hartley plans, mutual funds, and ordinary individual investors.

The Fed and Treasury felt compelled to act. With help from the SEC, Paulson and Bernanke put their plan in motion over the weekend of July 13th.

How did they do it?

Paulson, a former Goldman Sachs CEO, knew that many hedge funds had prospered enormously by short-selling bank stocks and buying commodities, and that much leverage had been deployed into this winning strategy. He announced that the Treasury could buy unlimited stakes in and lend to F&F, aiming to stem a collapse in confidence in the U.S. financial system. The Federal Reserve separately authorized F&F to borrow directly from the central bank, immediately providing them access to capital. As markets opened sequentially around the world, U.S. financial shares soared in lockstep, forcing a panicked reversal of the strategy that had, theretofore, been the biggest winner. Two days later on July 15th, the SEC added momentum by making it illegal to short Fannie Mae, Freddie Mac and 17 other financial institutions without borrowing the stock first (prohibiting the use of derivatives). As such, speculators couldn’t act on their perceptions of these protected stocks, that “this is overvalued...I want to short it here.”

This coordinated intervention was aimed to propel U.S. banks’ and financial institutions’ shares higher, and **to enable them to raise badly needed equity capital** to shore up their decaying balance sheets. And as the commodity positions were unloaded as part of this unwind, perceived inflation pressures abated.

What now?

Authorities everywhere deny that taxpayers will need to supply direct funds to shore up F&F. That remains to be seen. In our opinion, taxpayers will be asked to foot the bill for F&F’s excesses, but not through such overt measures as higher taxes—that’s too politically unpalatable, especially in a softening economy. It will instead likely come through inflation and/or a long-term monetary devaluation of the dollar.

With much of the excess leverage in the financial markets purged, further Federal Reserve rate cuts are now possible. We believe the Fed will renew its campaign to subsidize banks through ultra-low rates. This subsidy comes **at the expense of the frugal**. Unfortunately, those who put money into bank deposits and CDs at 1% – 2% are underwriting the very inflationary pressure that is reducing their real wealth, which is why some prudent risk-taking is necessary. Or, if depositors balk at lending to banks on such meager terms, banks will have to curtail lending volumes, which could lower asset prices further.

Because of this and our inability to forecast precisely how long the deleveraging process will continue, we initiated some risk-reduction changes to equity portfolios in September. As routine bank collapses also don’t help instill confidence in the system, we believe these changes have proved all the more prudent.

But—and this is a big **but**—monetary authorities can’t manipulate market action forever. Inflation remains an ominous risk as the United States’ fiscal position deteriorates—negatively impacting the value of the dollar as well as Americans’ share of global wealth. Remember, it took Paul Volcker many years and a sustained

campaign of raising short-term interest rates to 7% above the rate of inflation to purge the inflation dragon.

Is the global growth story over for the longer-term? No. The international economy may be softening currently due to tight global credit conditions and reduced U.S. demand, **but it would be a serious mistake to invest in a manner that assumes that China and India's economies will fade away quietly, never to be heard from again.**

It's important to remember that past returns are *not* predictive of future returns. Because foreign stocks and commodities are down does not make them poor investments. Likewise, because certain financial stocks have rallied does not make them good investments. The world is an incredibly complex place and there are many unknowable interrelationships. Short-term moves,

market reactions to information and future economic activity are all unpredictable day-to-day. Adding to the challenge is that when institutions are liquidity-starved and credit is being drained from the system, all assets are at risk of being liquidated to generate cash. **But this indiscriminate selling itself creates opportunities.**

Like every one of its predecessors, this market sell-off offers the prospects of both pain and delight. It is our job to appraise the *long-term* risks and opportunities and to have other investors' irrationality and short-term orientation working in our favor. Our ultimate goal is to intelligently position clients even in the most confounding of markets; we do this by seeking high-quality investments that are transparent, undervalued, and have a significant upside potential over time. ■

TOP OF MIND

THIS YEAR'S GYRATIONS have challenged even the most seasoned investors. Under these conditions, it is hard not to succumb to general market sentiment and panic, but this is the very time that we need to remember the cardinal rules of investing. One of these is that market price movements **do not validate whether something is a good or bad investment.** Equally as important: crowds are great for picking restaurants, but not investments. Berkshire Hathaway's historical performance is an excellent illustration.

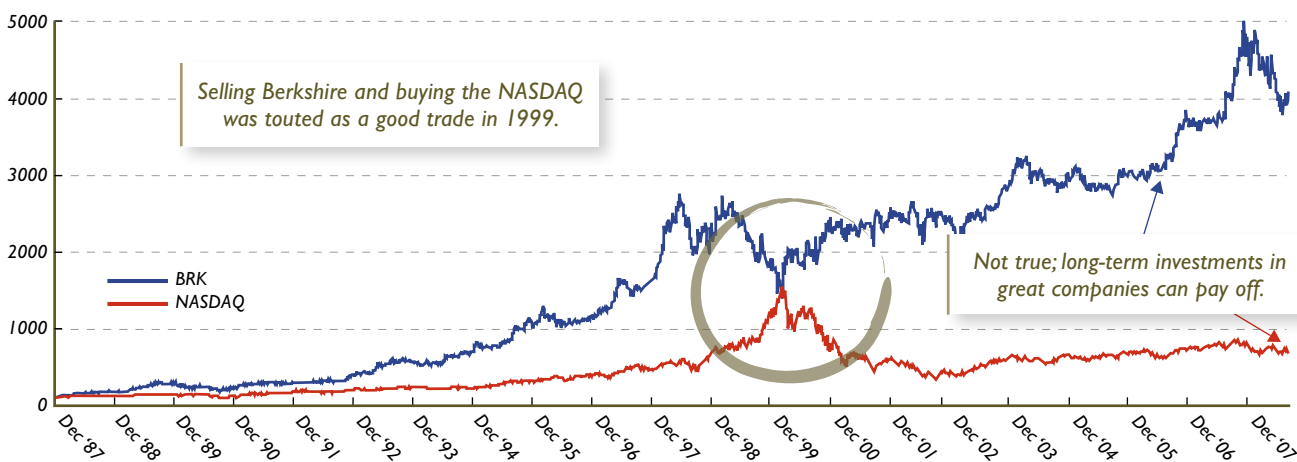
Warren Buffett is an indisputably astute businessman and investor. However, in 1999, many people judged Warren Buffett as being "out of touch" and that tech stocks were the best investments. As such, Berkshire Hathaway's stock price **was down over 40%** between March 1999 and March 2000.

If an average investor had followed the crowd in 1999—selling Berkshire Hathaway and buying the NASDAQ—he/she would have been feeling pretty smug for a few months. However, Berkshire Hathaway has returned over 9% annually from January 2000 to August 2008, while the NASDAQ has returned a negative (5.5%) over the same time period.

Lesson: Even though the media was calling for Buffett's head and Berkshire Hathaway's price was down substantially, the stock was a great investment. Long-term holdings in solid companies pay off; one just needs to have confidence in his/her analysis and the courage to tune out the cries of others—especially when they come from "market experts." ■

Value of \$100 Invested 12/31/1987

Source: Bloomberg



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OBERMEYER NEWS



BEST OF THE INDIES

We are excited to share the news that Wally Obermeyer was named by *Barron's* magazine as one of America's Top 100 Independent Financial Advisers in its August 18th issue. Ranked #38, this year marks Wally's second consecutive appearance on the list. The annual ranking, also referred to as the "Best of the Indies," was prepared by Winner's Circle, an independent securities research firm; the rankings were based in part on assets under management and indications of service quality.

For Wally, this success is clearly the result of a group effort: "I'm greatly appreciative of our clients and the entire Obermeyer team who have together helped us achieve this distinction. And I'm particularly proud that a Colorado-based firm is being recognized on a nationwide level for delivering solid investment returns and world class service."

Our firm has also learned that we will be included in *Worth* magazine's Top 250 Wealth Advisors. This list, appearing in the October/November 2008 issue, will be hitting newsstands shortly.

Again, these rankings wouldn't be possible without the continued support and business from our clients. **THANK YOU!**

Denver Office Opening its Doors

After a final clean-up of the construction dust, our Denver office is opening its doors. We are thrilled to have a physical presence in the Cherry Creek neighborhood, given our expanding client base in the Denver and Front Range region. We look forward to seeing you in our new office in the coming months.

Client Conference Call this November

Mark your calendars—we plan on hosting our next Client Conference call on Tuesday, November 11th. Call details will be distributed in a few weeks, as well as news of other initiatives to increase the frequency of our broader communications about the markets. ■

Past performance may not be indicative of future results. Different types of investments involve varying degrees of risk, and there can be no assurance that any specific investment will be suitable for an existing or prospective client's investment portfolio. Therefore, no existing or prospective client should assume that future performance of any specific investment or investment strategy (including the investments or investment strategies recommended herein) will be profitable or equal any historical performance levels.

Certain portions of our newsletter may contain discussions of recommendations as of a specific prior date. Due to various factors, including changing market conditions, such discussions may no longer be reflective of current positions or recommendations. Information included herein should not be construed as the receipt of, or a substitute for, personalized individual advice. A copy of our current written disclosure statement discussing our business operations, services, and fees is available upon written request.

ASPEN HEADQUARTERS:

OBERMEYER PLACE ● 501 RIO GRANDE PLACE, SUITE 107 ● ASPEN CO 81611 ● 970.925.8747

DENVER OFFICE:

3200 CHERRY CREEK SOUTH DRIVE, SUITE 480 ● DENVER CO 80209 ● 303.733.4305

800.337.0933 ● WWW.OBERMEYERASSET.COM

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