



A GLOBAL POWER SHIFT

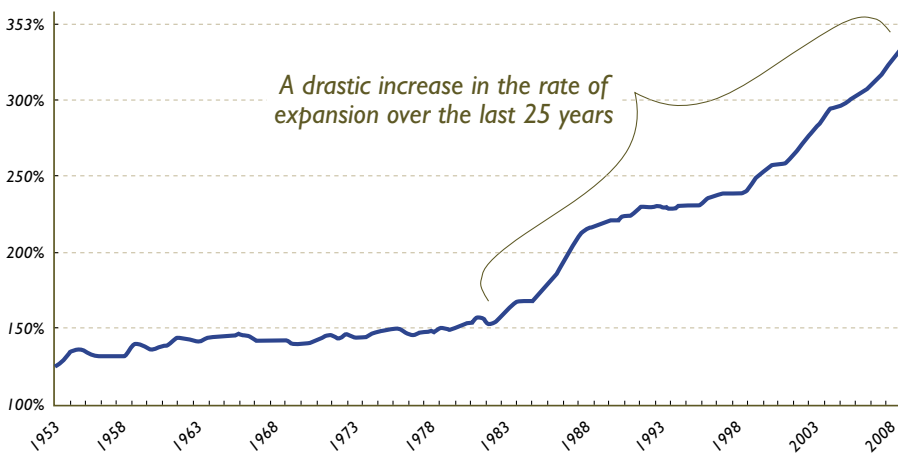
It is increasingly apparent that we are witness to an economic and financial power shift, one that is creating new global economic leaders, unseating Wall Street as the ruler of the international financial system, and making Ben Bernanke act more like Indiana Jones—going from crisis to crisis and narrowly escaping with his own life—than a stately central banker. The aftermath of the late 90s tech mania and subsequent credit euphoria has

set off a global banking crisis, a drubbing in the dollar, and an unnecessary economic slowdown in the U.S. These Wall Street-induced debacles came at a time when new economic powers were rising in Asia. As such, investors are now forced to rethink their ideas of risk.

HOW WE GOT HERE

Total Debt as a Percentage of U.S. GDP

Source: Free Lunch



When Paul Volcker finally defeated inflation in the early 80s by holding rates at positive *real* (above inflation) levels, a renaissance for financial assets began. What fed the stock and bond bull markets was a quadruple dose of disinflationary stimulus: a technology revolution, the end of the Cold War, surpluses in the basic goods that improve living standards, and lower trade barriers. Throughout this golden age Americans became emboldened to take on more and more debt because it was readily observable that debt used to acquire long-term assets often paid off in spades. This trend is clearly evident in the graph above.

The thing about debt is that there is a natural limit to how much individuals and financial institutions can take on. For individuals this limit is set by income, but for banks the limit is set by the Basel Accord, which defines the type of assets that can be borrowed against and to what extent.

The securitization market developed, allowing for bank lending volume to increase without violating Basel Accord rules.



IN THIS ISSUE

- A Global Power Shift
- Prospering from the Emerging Economies
- Reporting from Omaha



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This meant that loans could be both packaged as well as immediately resold to third-party investors. But it wasn't just traditional banks lending to excess; other entities such as mortgage companies were also eager originators of loans that were ultimately distributed to investors—loans that were underwritten by investment banks, that were blessed by ratings agencies and that were purchased by hedge funds and other global investors. So with the capital markets becoming the predominate supplier of credit, this newly developed source of cheap funds kicked off a frenzy in U.S. residential housing.

Parties, as we know, can only last so long before it's time to go to sleep (and wake up with a hangover), but they usually last long enough for people to adopt a belief system (backed by plenty of statistical data) that the good times will last forever.

To conclude this chapter, U.S. housing peaked and defaults began to occur within mortgage-backed securities. In this game of financial hot potato, many financial institutions got burned: their balance sheets were overstocked with warehoused mortgages (i.e., loans that they had not yet been able to package and sell), and their quantitative risk models weren't programmed to even consider a downturn in housing prices. Nowhere is this breakdown better summarized than by Jean-Pierre Roth, the head of the Swiss central bank, who said,

The actual losses incurred in the area of mortgage-backed securities clearly surpassed the potential level calculated by sophisticated statistical models, and the liquidity hemorrhage suffered by the banks was greater than the most pessimistic scenarios had suggested. In other words, the risk-measuring systems failed despite the fact that they were being monitored by the best experts around.

As such, the stocks of banks (often viewed as an investment safe haven until recently) have steadily declined since last fall as managements have disclosed write-down after write-down. Additionally, many of their remaining loan receivables will need a robust economy, high asset prices, and a resurgence in liquidity to be fully realized—a difficult prospect at best.

THE EMERGING ECONOMIES

While the developed world has experienced the rise and fall of these two financial manias, new economic powers have been rising in Asia. As the developed world outsources much of its manufacturing production to emerging regions, these economies are experiencing newfound economic prosperity. With this shift, wealth is essentially being transferred to these nations, significantly increasing their standard of living and elevating their populations to become a powerful set of global consumers. (See *graph on opposite page*)

As a result of this new economic world, these emerging economies clearly demand consideration. The investment

PERFORMANCE OF BANK STOCKS: December 1997 to June 2008

Source: Bloomberg

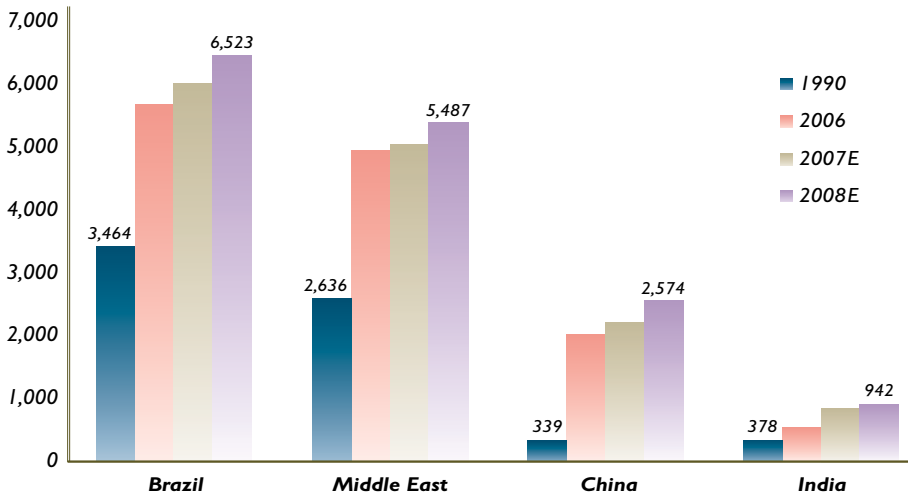
KWB BANK INDEX (U.S. Banks)



SURGING PURCHASING POWER IN THE DEVELOPING WORLD

Source: U.S. Global Investors

GDP/capita, current USD



thesis to capitalize upon the incredible Asian growth story is based on supplying basic goods such as food, fuels and metals that are in increased demand as hundreds of millions of new consumers are added to the global economy. This includes steel, copper, zinc, oil, grains, fertilizer, etc.—the building blocks of civilization. The shares of companies that the world relies on to find and produce what these new consumers need should no longer be thought of as low-quality cyclicals, but rather as premier investments because they do what is necessary and have real assets and real earnings. *This is in stark contrast to the rationale behind the Tech and Housing bubbles, which was based upon unrealistic expectations of double- and triple-digit compounded earnings growth rates and the perpetual availability of NINJA (no income no job or assets) loans, respectively.*

It is too soon to predict whether the double hits of skyrocketing food and fuel prices will trigger a stagflationary recession in the U.S., but there is little doubt in our minds that the optimistic economic and earnings forecasts in the U.S. will have to be scaled back. We, however, are more focused on the dynamics at work in the **global** economy and whether the current stresses are enough to cause a severe, prolonged global downturn. We don't believe this to be the case.

Our Investment Committee's mission isn't to solve the world's problems; it is to identify and understand changes in risks and opportunities that accompany major economic shifts. We continue to be of the view that the best investments are those that benefit from improving living standards among the emerging middle class and that the competition for resources is just beginning to heat up. While this process won't unfold in a straight line, and policy responses will sometimes be jarring, over time we are likely to see a continual transfer of wealth from the users of resources to the owners of resources. It is imperative to be forward-looking in investing and to position our clients for coming economic prosperity, rather than relying on the old world order and what has worked in the past. ■

CLIENT CONFERENCE CALL

On May 29th, we held our inaugural **Global Markets Client Conference Call** during which our Investment Committee commented on current market dynamics and our overall positioning. Our goal in introducing these calls is to provide our clients more frequent market updates to complement our quarterly newsletters and in-person meetings. We covered some of the material mentioned in this first article, "Marketpoint," and reviewed the *Fs* of the current investment climate (e.g. falling dollar) and the *As* (e.g., ample pricing power) that we are focused on to position our clients to benefit over the long run. For the clients who dialed-in, thank you for your participation and questions. For those of you who weren't able to make it, you can still listen to a replay of the call through **August 1st**. We plan on conducting these client conference calls every 3–4 months. We encourage any comments or questions as this is a new endeavor for us! ■

To access replay, dial

1-800-642-1687

Passcode: 4655-8456

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TOP OF MIND

REPORTING FROM OMAHA

Three members of our Investment Committee (Wally, John and Lonny) traveled to Omaha this past May to join the masses at the 2008 Berkshire Hathaway Meeting. Attendance was reported to be 31,000—a new record—and this year's Question and Answer session lasted five hours. As always, Warren Buffett and Charlie Munger shared their pearls of wisdom, making the trip very worthwhile. We've summarized some of their key points below:

1. To train oneself for investing one should read everything in sight. Absorb the lessons of Benjamin Graham's *The Intelligent Investor*, especially chapters 8 & 20 and the foreword.
2. Buffett and Munger never talk about where the market is going over the next week, next month or next year. It's a waste of time and energy.
3. When it comes to investing, they ignore 99% of what they see.
4. They consider whether a stock is attractively priced as a share of a business.
5. They would still buy a quality stock if they knew the market was going to be closed for a couple of years.
6. In investing you have to have an attitude that divorces you from being influenced by markets.
7. Stock markets will give you bargain prices; private business owners won't.
8. It's not worth risking financial ruin for a couple of extra percentage points.
9. While Buffett and Munger don't like inflation, they'll probably make more money over time because of it.
10. Your best asset is yourself. Invest in it!

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.

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