

March 31, 2008

Dear Client,

2008 started with a bang, with stocks dropping from the start of trading. For the first time ever, we decided to go largely to cash in your accounts, based on our concern that the US consumer was tapped out, and had no credit available for further spending. We kept some funds in the oil sector and several special situations, and placed some in instruments that historically appreciate during market declines. We believe this proved to be a sound strategy. By selling, we harvested what we believe were attractive gains in certain drug and solar stocks, as well as diversified industrial companies. Since that time, many of these securities are down 20% or more, and you have mostly avoided that pain.

So what's ahead? Recession and deflation, inflation or stagflation? Regardless, we are expecting more pain to the downside in stocks. With tight credit and commodity prices continuing to skyrocket, consumers may be buying less. If the government fails to act quickly enough to re-inflate the economy, the economy may deteriorate, possibly a great deal. This is the deflation case, where all financial assets depreciate, and cash is king. If banks and savings and loans lose their net worth through real estate losses on foreclosed homes, they may not be in a position to lend. A typical bank lends out 6 times its net worth, so foreclosures and consumer loan losses have a multiplier effect on consumer credit. Ultimately, loan losses may leave some banks with negative net worth. Government and industry insurance may be called upon to bail out some of these institutions, but the reduction in net worth will mean less loan funding, which could have a domino effect. Reduced lending could mean financial hardship for the American consumer, whose spending constitutes about 66% of the American economy. In this environment, a fair number of leveraged companies, including hedge funds, certain investment banks, and even some manufacturing firms may go under. If this leads to a panic, things could, in our opinion, get very bad.

The federal government's response to the credit crisis has focused more on reducing interest rates and putting a small tax benefit in the hands of consumers, rather than on solving the structural liquidity issues with U.S. lenders. Today banks, mortgage companies and other lenders are unable to lend funds because they can't sell their loans or borrow against these assets until the loans become viable, or so-called "performing loans". That will not happen until lenders reset the terms of these loans to match economic reality, and the government is not yet pressuring these institutions to do so. Until these loans are reset and the economy put on a sustainable long-term path, we will face the kind of prolonged decline seen by Japan over the last two decades, where government policy favored low interest rates over fixing bad loans. Under these conditions, a decline in the Dow to between 10,000 and 11,000 is not unthinkable. If a panic sets in, things could be even worse.

Under this scenario, we do not want to own stocks. Only a few carefully selected issues may be in your account and cash (and some bonds) will be king. Keep in mind that I do not believe foreign stock performance will decouple from domestic stock performance in the event of a market decline. This means that nearly all stock markets around the world could fall.

As the economy weakens, accommodating federal monetary policy (low interest rates and high budget deficits) may weaken the U.S. dollar against stronger foreign currencies, leading to price increases on both foreign and

domestic goods. I believe this is the classic 1970s case of stagflation, a mix of inflation and very slow growth. Unless the US economy declines enough to dramatically slow the world economy, stagflation will be a more likely outcome than deflation.

While we remain vigilant for signs that the slowing economy will cause a drag on commodities, there are many reasons to believe that this will not happen anytime soon. Meanwhile, inflation has spread globally, with the Middle East and Russia awash in petrodollars, and China facing strong inflationary pressure from its amazing growth. These countries will need to combat inflation by raising interest rates, which may continue to raise the value of their currencies against the dollar. As a result, we are looking to commodities, dividend-paying foreign stocks, and certain unique special opportunities abroad, to provide a hedge against inflation and the decline of the dollar, as well as seeking reasonable income.

While we still have a slight short-term bias in favor of the stagflation scenario, recent events involving Merrill, Bear, and Carlyle Capital have moved the needle to near neutrality on that issue. As such, we will be watching our positions very closely, and remain vigilant to a more severe downturn in the global economy.

Regards,

Stanley Q. Mok
Principal