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Dear Client:

We have a lot to discuss, given the events of the last month. In our last newsletter, we wrote that "the stock market has indeed moved to the downside, though not by as much as we thought possible." Since then, the market has declined again, approaching most of what we thought possible, and we now expect it will decline further. Nouriel Roubini, the economist who most accurately predicted this crisis, believes we are in for a steep, prolonged recession, and that the market, as with most all financial assets, has quite a bit more downside. Until the government intervention in mid-September, we thought depression was the better term for the kind of asset deflation and collapse of financial institutions that we were seeing. While the government is finally doing what it can to prevent this from becoming a full-scale depression, we believe that much of the downturn cannot be prevented. This decline is the culmination of a long period of financial mismanagement by America's government, its business and financial institutions, and millions of consumers. Until we work off a fair bit of our national and individual debt, America will lack the financial strength to move on.

Whatever we call this downturn, we have seen a huge increase in at-risk financial institutions, including the recently federalized Freddie Mac and Fannie Mae, AIG (the US' largest insurance company), Washington Mutual, Citibank, the recently acquired Merrill Lynch, Wachovia Bank, and the bankrupt Lehman Brothers. While your accounts have largely been out of financial institutions for over a year now, these companies are some of America's largest conduits of investment capital. Declining home prices and home loan values, as well as other troubled debt, has reduced capital at these institutions, causing them in turn to curtail their lending and investments. As they terminate or foreclose on lines of credit, they have created a vicious cycle, involving homeowners, indebted businesses, and even holders of so-called credit default swaps, who have agreed to insure a portion of business debt.

Market fear has further accelerated this decline, partly because without clarity in corporate disclosure, there is great uncertainty about the value of the loans and other long- term investments held on the books of these companies. Recently adopted accounting rule, SFAS 157 also has a role in the current market disruption. This rule, requiring the markdown or markup of certain assets to specified "fair value," was adopted last year, but its implementation was delayed as to certain "non-financial" assets (including real estate and real estate loans), based on financial and accounting industry concerns. Some businesses adopted the rule in full prior to its mandatory implementation date. Unfortunately, in markets like this, where there are essentially no buyers for many real estate loans, SFAS 157 requires that the assets be marked to zero. That is a harsh result for banks, which are able to collect at least a significant portion of these loans if held to maturity, or if the properties are foreclosed. We believe that SFAS 157 is not designed for extreme market conditions, and should be amended to allow the companies to record the "hold to maturity" value of these loans on their books, or to amortize their losses over time. Such reform will be necessary to arrest the decline of our banks.

After nearly six months of inaction, the government allowed Lehman Brothers to fail in mid-September. Then, as panic took hold of the markets, the government took major steps in September to contain the liquidity crisis. In the week of September 15, the government took the following actions to stabilize financial markets:

1. The US treasury provided an $85 Billion line of credit to AIG, to help it avoid a run on its assets after AIG's credit rating was downgraded and it was unable to sell off assets quickly enough to satisfy its obligations. In exchange the government took a controlling interest in AIG. With the government backing, AIG is not expected to need much of the line of credit as creditors and customers become comfortable with the company's position. The ultimate cost of this action is expected to be less than the amount loaned, due to the security and shareholder interest obtained by the government, and the fact that AIG was not insolvent.

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2. The government announced that it would guarantee holders of money market funds for one year against losses from a decline in assets. Several months before we had moved your money from a higher interest paying money fund into a fund invested solely in U.S. treasury-backed instruments, because of the risk of losses. By September, several money market funds had announced liquidations at less than the full value invested, due to losses in housing related instruments and certain other risky assets. We do not currently plan to move your funds into a money fund paying higher rates until the full risks of such investments are clarified. The cost of this program is expected to be up to $50 Billion.
3. Treasury Secretary Paulson and Fed Chairman Bernanke proposed a new federal agency to buy up to $700 Billion in mortgages and other financial instruments from financial institutions. The plan gave essentially unlimited discretion to the Secretary with respect to how it would be operated, and protected him from any legal recourse. Many members of Congress were not comfortable with that structure, and have asked the Secretary to work with them to put more constraints on the program. Economist Roubini, and leading Democrats in Congress, including House Financial Services Committee Chairman Barney Frank, previously offered a similar solution, providing for an agency to acquire bad loans, but failed to get support from the administration. Under their plan, the government would pass on much of the benefit of the loan discounts to homeowners who have not been foreclosed upon, and who are willing to sign new fixed rate loans. The purpose of the latter plan is to keep homeowners in place, avoiding further foreclosures, which only worsen the housing market, reduce local tax revenues, and lead to neighborhood blight. Paulson's plan remains a work in progress, but some form of bailout is almost certainly needed to prevent the complete meltdown of the financial system, to insure that borrowers with good credit will be able to find financing, and to stabilize the housing market. As of this date, it is unclear if Congress will pass this plan.
4. The SEC barred short sales in hundreds of financial stocks. Short selling is the sale of stock you don't own, with the promise to buy it back later. The objective is to make money with the fall of a stock.

With the exception of the ban on short selling, we believe that these steps by government are helpful in stemming the free fall that existed at the beginning of that week. But the decline in the market and economy is likely to continue for quite awhile, albeit at a somewhat slower pace. Very strong systemic problems remain, including a lack of faith in our financial institutions, and a significant downturn in the economy, which is already underway and contributing to growing unemployment. In addition, we believe that the mere size of the government's intervention is likely to cause the US dollar to resume its prolonged decline against major foreign currencies, as US debt has been substantially increased. With so many institutions at risk, the Federal Reserve and US Treasury are printing huge amounts of money, in a combination of bailouts, loans and investments, plus tax credits and incentives for consumers, homebuilders, and possibly underwater homeowners. We would expect this to have a variety of effects in the global economy, both intended and unintended.

With the enlarged debt, it will be more difficult to reduce the federal deficit, to fix long-term problems with federal entitlement programs, and for US consumers to reduce their personal debt. If the dollar decline continues, US consumers and businesses will eventually face higher prices for imports (and in turn for domestic products), higher federal taxes, and higher interest rates once the economy gets going. Federal intervention will probably slow the decline among large institutions, and may reduce the number of banks that fail, but the credit crisis will at best devolve from a financial vortex to a broader economic decline, with tougher lending standards and less money in the system than before. Certain areas, including credit default markets, will still have very large exposure. We can expect new rules and regulations governing bank lending, commodities trading, and credit default swaps. If the history of the government's acquisitions of defaulted loans during the Savings and Loan Crisis of the late 1980s and early 1990s is helpful, the actual loss to the government may be less than the amount of mortgages purchased, and the government's ownership of the distressed properties will bring some order to the underlying real estate market by slowing the flood of foreclosures.

We expect to see more failures of large businesses, and plenty of smaller ones, with some pain among their creditors, and borrowers. We also expect more bailouts, including likely assistance to Ford and GM. Fortunately, the large brokerage houses have in most cases segregated their risky investments from their customers' cash and securities by placing the customers' assets in separate subsidiaries, thus

protecting these assets from bankruptcy of the broker. So, for example, on September 15 the SIPC advised on its website that it expects not to need to pay any money to brokerage clients at Lehman Brothers.

So what's likely to get us out of this mess? Based on past deflation, the decline should continue until productivity gains are realized, and asset sales and savings rates have made a significant reduction in debt levels.

Besides the U.S. liquidity crisis, other risks to the global economy are lurking as well. The liquidity crisis is now spreading to Europe, where falling housing prices and bad loans are already causing problems, and may yet spread to China, which appears to have engaged in a fair bit of speculative construction and improvident loans during its own boom. Roubini and others expect to see repayment problems with sub-prime loans spread to other real estate loans, credit card debt, and even commercial loans. Bankruptcies and rising unemployment will only increase the problems for lenders in each of these sectors. Lastly, increasing global tensions with Russia, North Korea and Iran can only add to the growing economic uncertainty.

Our predictions last quarter were on the money regarding interest rates and commodities. We said that interest rates would stay flat through the November election, and probably year's end, and so far that is correct. Going forward, Treasury interest rates will need to stay low or go lower to keep the economy from collapsing.

With respect to commodities, we predicted that energy price increases would "slow or end at the close of the summer driving season". We also said "energy price increases should resume sometime next year, until there is a precipitous drop in the global economy, and thus demand for oil". We now believe that the drop in the global economy may be sufficient to extend the decline in oil somewhat beyond 2009, despite the long- term underlying growth in demand. Because even slight imbalances between supply and demand can result in large changes in oil prices, we could see oil prices falling well below the current price.

We seem to have erred a bit on the direction of the US dollar, which we expected to be flat or continue to decline. Instead, the dollar rose about 12% against the Euro in July and August, as declining flows into energy reduced dollar outflows. However, we are looking at the costs of the federal bailout and levels of U.S. public and private debt and adjusting our strategy to protect you against what we believe may be a long- term decline in the dollar.

What's looking good amid all of this misery? Unfortunately, we expect that the markets will be bleak for at least a number of months, and believe that cash should be invested in safe short-term instruments, which have a rather low yield. Yields on longer-term bonds are at historical lows, with yields likely to climb and bond prices, which move inversely to yields, likely to decline in value. Fortunately, most of your accounts now have very large cash positions, and a substantial hedge designed to minimize further decline.

As asset prices decline generally, we need to find a level of support, and really outstanding value, to induce us to resume investing. With stock prices for technology and other growth business coming down since mid-quarter, based on lower expected earnings, we expect to see more value toward the end of the year or early next year, both in the US and especially overseas. More than at any time since at least 2003, this is a good time to add cash to your investment accounts. With asset prices falling, your cash will be positioned for investment at historically attractive prices. We expect that for the next few years, American investments will produce below average returns, at least until we get our debts under control, the world starts to import more American goods, and America starts to become less dependent on imported oil. We will need to work hard, and generally look abroad, to provide you with stronger returns.

One special note: As we previously advised, Bear, Stearns & Co. Inc. has been acquired by JP Morgan Chase & Co., one of America's largest investment banks. Your securities, which were cleared and held in custody by Bear, Stearns, will now be handled by JP Morgan Clearing Corp. **Effective October 1, all checks for your accounts should be made payable to JP Morgan Clearing Corp**. Checks made out to Bear Stearns will not be accepted after the first two weeks following the change date. Your statements will now come from JP Morgan Securities Inc. and your account numbers will remain the same.

And one last item – next month is a national election. That election will decide much about how the government regulates the financial industry, and manages the economy and our fiscal policy. You have the right to participate in that decision. Please exercise your right to vote.

Sincerely,

Stan Mok
President