



Disturbances in world credit markets that began in 2007 continued to roil the economic outlook in the first quarter of 2008. Our concerns for stock, bond and real estate markets discussed in last quarter's letter played out in the first few months of this year.

Three chief threats, all detailed in our past letters and emphasized last quarter in "Fourth Quarter 2007 Economy Review", *Winter 2007*, fed upon one another to slow the U.S. economy this quarter. While there is reason for some optimism in the immediate-term, we believe these factors will continue to pose a threat in future quarters.

Due to the ongoing credit crunch, we witnessed extraordinary events this quarter, most notably, the March collapse of venerable investment bank, Bear Stearns. Investors are hoping that this event will punctuate the bottom of the financial liquidity crisis. We believe important lessons should be learned from this amazing story. These lessons are explored below in "Learning from the Collapse of Bear Stearns".

Meanwhile, increasing oil prices, mentioned as a leading economic threat in every quarterly Sharper ♦ Granite letter since "Oil, our Most Important Commodity", *Spring 2004*, continue. Four consecutive years of painfully higher oil prices brought us to \$110/barrel on January 2nd, 2008. High oil prices have the ability to lower corporate profits while simultaneously increasing inflation, thus constraining the Fed's ability to boost the economy by lowering short-term interest rates.

Finally, the residential real estate market continued its long march downward. This quarter U.S. construction spending saw its steepest decline in 14 years,¹ new home sales fell to a 13-year low,² and the foreclosure rate reached its highest level since 1985.³ Fundamentals suggest that overall home prices could fall 25% from their peak.⁴ If so, mortgages for 20 million homeowners would surpass the value of their homes, creating negative equity, a situation that generally leads to even more foreclosures.⁴

These three factors could combine to make the U.S. consumer less likely to make major purchases. For every \$1,000 a home price declines in a year, its residents spend \$90 less as they feel less wealthy. The U.S. consumer is indeed feeling less wealthy these days. This quarter the consumer confidence ratings declined to their lowest values in six years.⁵ Please read more about our economic outlook in "First Quarter 2008 Economy Review".

Due to these continuing threats, we continue to shift most Sharper ♦ Granite portfolios toward the "safer" end of their respective target ranges, continuing a process that began in 4Q07. For questions about the risk level of your portfolio and how it may have changed over the past two quarters, please contact your Sharper ♦ Granite advisor.

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Financial Markets Summary



In 2006 the S&P 500 Index experienced 29 days of price changes greater than 1%. That number increased to 65 in 2007.⁶ The pattern of high volatility continued once again this quarter, and perhaps even hit a local peak.

The S&P 500 Index led off the year with the worst two-week start in its history⁷ as investors experienced the *third* consecutive quarter with an official “stock market correction” of 10% in the Dow on January 8th. Then, on March 14th, as Bear Stearns liquidity rumors were circulating and the market was declining sharply, the CBOE Volatility Index (VIX) reached its highest point in over five years.⁸

However, on March 18th, following news of a Bear Stearns credit bailout by commercial bank, J.P. Morgan Chase, and the Fed, the stock market (as measured by the Dow) had its best percentage increase since October, 2002. This was followed a week later by the greatest three-day percentage increase in the Dow in over five years.⁹

Finally, the market closed out the last few days of 1Q08 with more losses to finish -9.4% (S&P 500 Index including dividends) -- the worst quarter for the stock market since 2002.¹⁰

Think picking stocks and sectors is ever easy? In our current market downturn ignited by the troubled real estate sector, common sense would say to stay away from real estate stocks and to buy pharmaceuticals, which are not tied to the economy, right? Wrong. The best performing stock in the S&P 500 Index this quarter was actually Pulte Homes (+4.7%), out of the real estate sector which broke even (-0.9%).¹¹ The worst performing stock in the S&P 500 Index was Merck (-34.2%), out of the pharmaceutical sector which finished -11.4% this quarter.¹¹ This illustrates yet another example of why it is important to stay diversified in all market situations.

Meanwhile, the Leman Aggregate Bond Index, which Sharper ♦ Granite uses as the benchmark for its taxable bond investment performance, returned 2.2% (bond price gain + interest payments) to bondholders this quarter. However, the bond market was anything but peaceful as certain types of bonds were rocked, including some generally safe instruments such as California municipal bonds. The liquidity drought interrupted some financial institutions’ routine processes of bidding for certain types of bonds. Thus, some categories of even the most highly-rated bonds fell sharply for days or weeks when demand temporarily dried up.

The average of all Sharper ♦ Granite client portfolios returned -5.4% (net of fees) this quarter at a risk level estimated to be 31% less than that of the S&P 500 Index.¹² This average risk declined from a level of 26% less than that of the S&P 500 Index last quarter.¹² If normalized to the same risk as the S&P 500 Index, we estimate that Sharper ♦ Granite client portfolios would have returned -8.0% (net of fees).¹² Thus, the average of all Sharper ♦ Granite client portfolios beat the S&P 500 Index on both an absolute and a risk-adjusted basis this quarter. ●

Learning from the Collapse of Bear Stearns

Former Bear Stearns CEO, Jimmy Cayne, used to be fond of saying, “We are the casino, not the gamblers”.⁹ His statement described a fundamentally sound way of doing business in the investment banking world. In investment banking, lucrative profits are made as these banks facilitate transactions by matching investors with the capital needs of the business world. Making a small percentage of huge dollar flow is a great way of making money in many industries. Nowhere is this easier to picture than in the casino industry. However, investment banks also have the option of gambling in the very “casinos” which they operate. After all, who has better insight into the workings of the markets than investment banks? Who knows the winning percentages and nuances of blackjack, craps and roulette better than the casinos?



Yes, betting in your own casino can be rife with conflicts of interest. And, in fact, much of the improper investing activity within these banks has been cleaned up by government regulators in recent years. However, “insider information” and “industry expertise” intersect in blurry space on Wall Street. And in this space investment banks seek profits in the *gambling* area in addition to the *operations* area. From 2000 to 2006 revenues from trading, or *gambling*, jumped from 41% to 54% of total revenues (\$70 billion) for the “Big Five” investment banks, Goldman Sachs, Morgan Stanley, Merrill Lynch, Lehman Brothers, and Bear Stearns.¹³

Beyond regulatory risk, these casino operators also run the risk of actually losing at the very games they manage and sometimes invent. How is this possible given that 1) they know the games better than anyone, and 2) stocks and bonds average *positive* winning percentages, unlike actual casinos games?

The scenario for losing bets becomes plausible when we first understand that investment banks do not play at the \$5 or \$10 tables as we do. They bet so much money that they have to play at the high-roller tables where bets are placed against other large, sophisticated institutions. When you see a 10 million share block-trade of Microsoft bought by some “large, savvy, financial institution”, by definition there is an equally-big fish who believes Microsoft stock will decline and who is more than happy to make the sale at that price. In other words, it is a zero-sum game for all market players.

Second, these investment banks do not invest only their own money. They borrow from commercial banks and other sources to make hugely leveraged bets. From 2002 to 2007 the ratio of tangible assets to tangible equity (size of the bets to size of the bank roll), rose from 30:1 to 41:1.¹³ With leverage this high it doesn’t take much to crash. At 33:1 leverage it takes only a 3% price drop to wipe out the entire capital investment.

The betting strategy that doomed Bear Stearns was similar to that which sank the enormous hedge fund, Long Term Capital Management (LTCM), and nearly sank the entire U.S. financial system in 1998.¹⁴ This strategy is like attending a horse race to bet on a horse that almost always wins. Of course, the odds on that fast horse are going to be so low that betting only \$10 would return just a small amount, say \$1. While you could only make \$1 on that horse with \$10 in your pocket, you could make \$1,000 if you borrowed from friends that day and collected \$10,000 before the race.

Years ago, when LTCM engaged in this game, they borrowed from every bank on Wall Street, every bank that is, except Bear Stearns. After all, Bear Stearns' philosophy back then was to be the casino, not the gambler. At one point LTCM was borrowing as over 100 times of its own money to place on "sure-thing" bets.¹⁴ When their star horse finally started losing, not only was LTCM in trouble, but so were the banks that lent them money. And when it came time for a bailout fund to buy distressed assets, all the major Wall Street firms participated except for Jimmy Cayne and Bear Stearns.

Despite making millions as LTCM's clearing firm (*casino operations*), Bear Stearns had lent little to LTCM for their bets and stood firm as the lone Wall Street bank who refused to lend for a bailout.¹⁴ That is what you get when you gamble with borrowed money, right? At a meeting among top Wall Street CEO's and the Fed to develop an LTCM rescue plan:

"The other banks thought it ludicrous. Bear was ...the least exposed. 'They had a different view of the world,' ... 'They're completely self-interested.' Suddenly these paragons of individual enterprise seethed with communitarian fervor. Purcell, CEO of Morgan Stanley, turned beet red. He fumed, 'It's not acceptable that a major Wall Street firm isn't participating!' It was as if Bear were breaking the silent code; it would pay in the future, (Herbert) Allison (president of Merrill Lynch) vowed."

— *When Genius Failed*¹⁴

That meeting ironically included a Citibank executive named Jamie Dimon, filling in for Citibank CEO, Sandy Weil. A decade later, Jamie Dimon happens to be the CEO of J.P. Morgan Chase, and the ultimate irony plays out. In 2008 Bear Stearns operates with a very different philosophy as it seeks to keep pace with the other investment banks who profit from gambling in their own casinos. Bear Stearns, like LTCM a decade ago, and like the other four investment banks today, borrows huge sums of money to invest in what was seemingly a sure thing. They borrow over 35 times the amount of their own capital to place on a horse that always seems to pay off.¹⁵

In 1998 LTCM's failed horse was named Russian Bonds. In 2008, Bear Stearns' horse is named Mortgage Backed Securities. Rated as high as AAA by the ratings agencies, many believed this horse would never go on a losing streak. But, of course, it did, and Jamie Dimon, whose bank places severe limits on leverage,¹³ was able to buy Bear Stearns in a fire sale for \$10 per share for J.P. Morgan Chase shareholders.

When the home buying market overheated, competition to provide mortgages was intense. Lenders offered loans that would begin at a super-low teaser rate, allowing home buyers to qualify for purchases they otherwise could not afford. Large financial institutions like Bear Stearns made money from the mortgage payments on mortgage-backed assets.

However, once these loan rates reset to higher levels some borrowers became unable to make their mortgage payments. For years mortgage-backed assets were reliable investments, but eventually that horse broke down and institutions that had loaned Bear Stearns money for its bet became nervous when they saw the horse begin to lose. They worried that the other lenders would ask for their money first, draining Bear Stearns' reserves before they could get their money back. It became a self-fulfilling prophecy called a "run on the bank".¹⁶ In a relatively good economy it took only a slight mortgage delinquency increase to finish Bear Stearns.

Nassim Nicholas Taleb, author of *Fooled by Randomness*, and *The Black Swan*, characterizes himself as a trader who bets a different type of horse.¹⁷ He recognizes the temptation to bet on the sure thing (even when it requires a lot of capital to compensate for the low payout rate). But Taleb takes the opposite bet. He bets small amounts on several long-shot

horses. He plays upon the following human bias -- if a person has seen thousands of swans, all white, he will tend to believe that only white swans are possible.¹⁷

Taleb believes that the investment world has more black swans than most realize. By betting on several different long-shot horses running in different races, he is 1) diversifying his bets and 2) taking advantage of the fact that most of the population will prefer to bet the “sure-things”, and thus he will receive a better price as few others are comfortable betting long-shots along with him.¹⁷ For Bear Stearns, which had survived two World Wars and the Great Depression, a losing streak for Mortgage Backed Securities was the black swan of death.

Markets are more efficient than most realize, and there are no “sure-things”. Investment gains are generated through building smartly diversified portfolios. Always, unforeseen world or economic events will come along and hurt some investments while simultaneously helping others. Some good ideas will fail, but we can protect ourselves through diversification. Sharper ♦ Granite seeks to construct portfolios consisting of several assets that tend to gain value over time for fundamentally sound reasons, but which will also counteract each other when shocking world and economic events occur. Bear Stearns, the fifth largest U.S. investment bank, filled with brilliant investment minds, went out of business overnight due the appearance of a black swan. We want to work with our clients to ensure that this never happens to them. ●

First Quarter 2008 Economy Review

The triple threat of tighter credit markets, declining home prices, and higher oil prices poses a significant headwind to the 2008 economy. In March unemployment ticked up to 5.1% as the economy experienced the biggest loss of jobs in 5 years.¹⁸

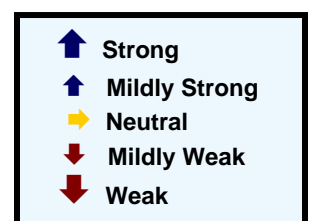
Our index of leading indicators is signaling an economic slowdown; however, a few factors are in place that could limit stock market downside potential. First, monetary policy -- the Fed aggressively cut interest rates by 2.0% this quarter. Second, fiscal policy -- most Americans will be receiving a few hundred dollars from the Federal government this summer. Also, global strength continues to show strength, especially in developing markets, and a weak U.S. dollar encourages foreign demand for U.S. products. Finally, insider buying is surging by managers at U.S. corporations.



Leading Economic Indicator Summary

↑ **Market Cycle:** The second quarter of each year is typically strong, historically averaging an annualized return of 10.9% with April tending to be the strongest month.¹⁹

Since September 18th we have been in an environment of decreasing interest rates, and the Fed will continue to decrease short-term rates further in 2008. Interest rate direction is the most significant short-term influence on stock prices.¹⁹ Market returns from 1955 - 2006 averaged only 7.2% in the 12 months following rate increases compared to 18.5% following rate decreases.¹⁹



On March 3rd the volatility indicator, VIX, rose to its highest level since March, 2003. Then, during the Bear Stearns collapse March 17th the VIX spiked even higher – above 33.²⁰ Often, spikes in the VIX to the mid-30's represent a crescendo of fear and set the stage for improving market conditions. When these levels of fear are reached, many investors have already pulled their money out of the markets, presenting the potential for cash to move back into the markets.

In fact, the March 17th Bear Stearns collapse may have marked a near-term low point. Through April 1st we had three 2.5% up days in the last three weeks. Historically, this type of market behavior marks a bottom. In fact, the first week of 2Q08 was the best Nasdaq week since 2006 and the best Dow start to a second quarter since 1938.²¹

↑ **Political Cycle:** We are moving into the fourth year of President George W. Bush's term. Traditionally, the third year in the presidential cycle is the strongest, but the fourth year is second best.¹⁹ Since World War II, the fourth year of the presidential cycle has seen the S&P 500 post an average gain of 8.6%.¹⁹ Eleven of the 14 post-WW II fourth years have been positive.¹⁹ On average, the second and fourth quarters of a president's fourth year have been best, averaging 3.2% and 3.1% respectively.¹⁹

↓ **GDP Growth:** Gross Domestic Product (GDP) is the official measure of the U.S. economy. It is a measure of all goods and services produced in the United States. 4Q07 GDP was confirmed in March to have grown at a 0.6% annual rate²², slow growth, but not yet in recession range. This represents the 25th consecutive quarter (six full years) of expansion, or positive economic growth, since the official recession of 2001.

↓ **Purchasing and Manufacturing:** The Institute of Supply Management (ISM) Index, the key manufacturing indicator, is in slight contraction. The ISM showed contraction in December, slight expansion in January, then took the biggest drop in five years in February to a level of 48.3 before recovering slightly in March to 49.6.¹ While levels below 50 indicate contraction, in past recessions the ISM is usually lower, in the range of 43 – 44.²³

The most recent manufacturing indicator was the Philadelphia Fed Manufacturing report, which plunged initially in January, then declined further in February and rebounded slightly in March.²⁴

→ **Inflation Control:** The most widely accepted measurement of inflation is the Consumer Price Index (CPI). The core CPI, which excludes volatile food and energy prices, advanced at a rate in the upward range of that targeted by the Fed. In January and February the year-over-year core CPI rate was 2.5% and 2.3% respectively.²⁵

The Fed's preferred measure of consumer prices, the Core Personal Consumption Index, rose at a calm annualized rate of 1.2% in February.²⁶

However, total CPI inflation with food and energy prices included rose at an annualized rate of 4.8% the first two months of the year. This follows a 4.1% total CPI increase in 2007. Thus, with food and energy factored, inflation is running high.²⁷

↓ **Oil Price Control:** Oil prices surpassed \$110/barrel for the first time March 12, 2008. Oil prices rose 12.0% in 1Q08, following the 47.5% increase in 2007.¹¹

This continues a disturbing trend. Oil is a key input to so many business and consumer products. Its price movement can greatly affect consumers' abilities to travel and purchase leisure-time products. It also impacts the profitability of corporations that produce plastic containers, fly airplanes, drive trains, build trucks or manage hotels. Oil prices, while volatile, have such a strong influence on the overall economy that they must be watched closely.

Oil prices rise and fall in long cycles of investment and payback as refinery capacity cannot be added and shuttered quickly enough to respond to changes in world demand. The world is paying the price now for underinvestment in oil production and refining throughout the 1980's and 1990's.²⁸

- ↓ **Consumer Spending:** Total consumer spending rose in December, January and February,¹ but at the slowest pace in a year.⁹ Retail sales continued a pattern of slight declines through February. February registered a 0.6% decline, seasonally adjusted from a year earlier.²⁹

Finally, Moody's Investor Services is projecting 2008 to be the worst spending year since 1991,³⁰ and consumer confidence in March reached its lowest level in five years in the Conference Board's index⁵ and the lowest level in 16 years in the University of Michigan/Reuters' index.³¹

- ↓ **Business Capital Spending:** Corporate profitability and balance sheets continue to show strength,³² which is key to helping the business community weather the current credit crunch. That is, in this time of difficulty finding loans, many businesses will be able to draw on their large cash reserves.

However, the Duke University/ *CFO Magazine* survey reached its lowest business spending outlook in six years and revealed that most CFO's believe we are in recession.³³ The survey showed pessimists outweighing optimists 9 to 1.³⁴

Furthermore, corporate hiring plans are at their lowest level since 4Q04. A net of 14% of employers plan to add staff in 2Q08.³⁵ Not surprisingly, the construction industry showed the weakest hiring trends.³⁵ In fact, U.S. construction spending fell 1.7% in 4Q07, the largest drop in 14 years.¹

- ↑ **Investor Sentiment:** The bull/bear ratio in the Investors Intelligence Survey has turned slightly bearish.³⁶ The bearish sentiment in this measure is considered a positive leading indicator for the stock market as it suggests that worried investors may have already sold their stock positions, providing future potential cash to flow into the market, especially with low interest rates making bonds an unattractive competitive investment.

The high VIX volatility readings discussed in the "Financial Markets Summary"

- ➔ **Corporate Earnings:** 4Q07 earnings fell 3.3%, excluding sub-prime write-downs. Most of this damage was linked to housing and the credit-market turmoil.³⁷ Outside of the financial services and home construction industries, earnings have been solid to date.

Overall, 4Q07 earnings relative to their stock valuations are still excellent. Stocks do not appear to be overvalued relative to historical norms.

- ↑ **Insider Trading:** Significant insider buying implies that managers have positive information about their company's outlook. Insider buying increased to a 30-day moving average of \$50 million/day at the end of this quarter, the highest reading in well over a year.³⁸

- ↓ **Merger and Acquisition Activity:** As expected, the private equity that was driving much of the M&A activity has dried up significantly due to the tightened credit environment. Tighter credit means higher costs of borrowing for leveraged buy-outs. The private equity bubble is in fact bursting. In 2007 the average buyout price was 15 times cash flow, nearly a fourfold increase from 2002, matching the frothy level reached prior to the LBO market blow up of the late 1980's.

One bright spot this quarter was the successful IPO of Visa, the largest IPO in history. ●

Notes and Acknowledgements:

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4. Paul Krugman, Professor of Finance, Princeton as reported in "How Bad Is the Mortgage Crisis Going to Get?", *Fortune*, March 31, 2008.
5. Conference Board and Haver Analytics, March 25, 2008
6. BTN Research, January 28, 2008
7. BTN Research, January 21, 2008
8. CNBC, March 3, 2008
9. CNBC, March 28, 2008
10. 2Q02 returned -15% for the S&P 500 Index
11. Indexes used: Dow US Real Estate (IYR), Dow US Healthcare (IYH), Goldman Sachs Oil Index (OIL)
12. Global Investment Performance Standards (GIPS) Original Dietz Method used to calculate returns. Arithmetic average used for return measurement. Performance is net of fees and may include assets tracked for clients that lie outside Sharper ♦ Granite direct management. Such assets total less than 4% of total assets. All client portfolios weighted equally in calculation of average client performance. S&P 500 Index returns include dividends. Past performance does not guarantee future results. Normalization to similar risk as S&P 500 uses weighted average beta of all client portfolio assets, then normalizes to beta = 1.0 (S&P 500 Index beta) using the Securities Market Line (SML). The SML is constructed as a line on the beta-return chart between two points, A and B: A is the point representing "risk free" at beta = 0, return = 3 month return of the 90-day Treasury Bill rate on the last day of the quarter as posted in the *Wall Street Journal*. B is the point representing the "market return" at beta = 1, return = 3 month total return (including dividends) of the S&P 500 Index. Beta (asset) = covariance (asset monthly price %Δ vs. S&P 500 Index monthly price change) / variance (asset monthly price %Δ) using Yahoo! Finance historical price data.
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24. Philadelphia Fed, March 20, 2008
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37. MarketWatch, March 27, 2008
38. Insidercow, March 28, 2008

Questions?

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