

SHARPER ♦ GRANITE

Optimal Portfolio Management



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Some stability in world markets returned in May, only to give way at quarter end to renewed fears of the “Big Three”: increasing oil prices, decline of the residential real estate market, and the ongoing credit crunch.

At quarter end the Dow registered an official bear market, defined as a 20% decline from peak to trough.¹

Increasing oil prices, mentioned as a leading economic threat in every quarterly Sharper ♦ Granite letter since “Oil, our Most Important Commodity”, *Spring 2004*, continued this quarter. Four consecutive years of painfully higher oil prices brought us to \$140/barrel on June 6th, 2008, when crude rose an unprecedented \$11/barrel in a single day. Oil prices finished the quarter up 39%, more than doubling in the last 18 months.² High oil prices both lower corporate profits and fan inflation, thus constraining the Fed’s ability to boost the economy by lowering short-term interest rates.

Real estate markets continue to free fall. Housing starts at the end of 2007 fell 40% from the previous year.³ Fundamentals suggest that average overall home prices could fall 25% from their peak.⁴ The Case-Schiller home price index fell 15.3% in May from the previous May.⁵ Coastal prices are falling faster than they are elsewhere. In the Los Angeles and San Francisco metropolitan areas, where many of our clients live, prices fell 22% and 20% respectively in 1Q08 from 1Q07.⁵

The last housing recession lasted six years in Los Angeles from 1990-96 but hit a peak quarter-over-quarter decline of only 10%. We are now 1½ years into this housing recession and thus may have much longer to go. On a bright note, eight metropolitan areas actually saw price increases this quarter, a potentially positive early sign.⁶

Driving the markets even more than oil and real estate prices has been the subprime mortgage crisis. At quarter end concerns resurfaced regarding the health and lending ability of many banks amid additional announced writedowns of subprime mortgages assets. These fears, led by Lehman’s disappointing earnings announcement and management shakeup, sent not only bank stocks, but also bank-backed bonds and preferreds tumbling as the quarter closed.

These “Big Three” factors are combining to strain the U.S. consumer, the dominant driver of the world economy, and make her feel less wealthy. For example, the average American is now allocating 6% of disposable income to gasoline, up from 3% two years ago.⁷ For the average home owner with 50% equity in her home, the 25% price drop suggested above equates to a loss of half the home’s equity. And if she does turn to a bank for a home equity or business loan, she is finding terms less favorable due to banks’ aversion to lending. No wonder this quarter the University of Michigan consumer confidence rating declined to its lowest value ever.⁸ Please read more about U.S. consumer behavior and the other key economic variables we track in this issue’s “Second Quarter 2008 Economy Review”.

Financial Markets Summary

In May the S&P 500 Index rallied off the Bear Stearns bailout by J.P. Morgan Chase, making up nearly all of its 1Q08 drop. Then, the Dow had its worst June since 1930, falling over 10%.⁹



Renewed reports of financial institution weakness at quarter end sent the major indexes back down to their March lows, a

level 20% below their October highs. At this widely discussed 20% level, called a “focal point” by game theorists, the market may rebound, as Goldman Sachs analysts predict, from what market technicians call a supported “double-bottom”, or, if the support level doesn’t hold, it may fall significantly further.

The S&P 500 Index with dividends finished -2.7% for the quarter and -11.9% for the first half of the year. The basic materials (+7%), energy (+18%), networking (+12%), utilities (+9%), tech (+5%) and Latin America (+11%) sectors did exceptionally well this quarter.² Financials (-21%) and healthcare (-13%) again suffered the most.²

Meanwhile, bonds did as poorly as stocks this quarter amid fears of increasing inflation and decreasing credit quality. The Lehman Aggregate Bond Index, which Sharper ♦ Granite uses as the benchmark for its taxable bond investment performance, returned -1.0% (bond price gain + interest payments) to bondholders this quarter. Worse, some generally safe instruments, such as California municipal bonds and bank-backed preferreds, declined significantly, rattling investors that are holding these presumably low-risk asset classes.

The average of all Sharper ♦ Granite client portfolios returned -1.2% (net of fees) this quarter at a risk level estimated to be 35% less than that of the S&P 500 Index.¹⁰ This average risk declined from a level of 27% less than that of the S&P 500 Index at the end of 2007 as we continue to shift our clients to the safe end of their target portfolio range.¹⁰ If normalized to the same risk as the S&P 500 Index, we estimate that Sharper ♦ Granite client portfolios would have returned -2.0% (net of fees).¹⁰ Thus, the average of all Sharper ♦ Granite client portfolios beat the S&P 500 Index on both an absolute basis and an estimated, risk-adjusted basis this quarter. ●

Lessons about “Sure-things” from Big Brown

Big Brown, a monster of a thoroughbred, entered New York’s Belmont Stakes on June 7th as one of the heaviest betting favorites ever to win the Triple Crown. After winning the Kentucky Derby and Preakness each by five lengths, the betting community gave Big Brown an 80% chance of winning.¹¹ Trainer Rick Dutrow proclaimed, “the race was a foregone conclusion”.¹² The race was also widely assumed by fans, analysts and the media to be the first Triple Crown accomplishment in 30 years.



Big Brown finished dead last in the race. The winner, Da’ Tara, was the longest shot in the race, given only a 2% chance of winning by bettors.¹¹ Post-race examination showed Big Brown to be healthy. He just didn’t have it that day.

But why such a strong presumption that this event would occur? Since Affirmed last won the Triple Crown in 1978, ten other horses won the first two races of the Triple Crown only to lose in the Belmont. Winning all three races is a monumental task even for a horse who is much better than his three-year-old rivals. To win the Belmont, Big Brown had to win his third major race within a five week period. This schedule permits far less than desired recovery time for most racehorses. None of the other eight horses had run two races in the previous five weeks as Big Brown had.¹³

Big Brown faced other challenges. The Belmont is an exhausting 1½ miles, far longer than most other horse races. Neither Big Brown nor any others in the race had run that far before.¹³ Big Brown had beaten some of the same horses in previous races, but horses mature at different rates through their three-year-old year (Triple Crown age). Finally, he had a minor pre-race hoof injury. There were many possible reasons why Big Brown could lose, but few were given much attention. Fans and the sports media were focused only on the “sure-thing”.

In past quarters we explored the allure of the two extremes of investment probability. At one extreme is the “lottery ticket” bet that holds the potential to pay millions in a rare event – the world of penny stocks, keno, and Hollywood starlets. This phenomenon came into focus for the investment world during the tech bubble years when Fed Chairman Alan Greenspan helped explain why investors would pay huge premiums for dot com companies, likening them to “lottery tickets”, whereby most would fail but a few would generate tremendous wealth. At this extreme, dreams of outsized riches overwhelm rational evaluation of “true odds” and “fair returns”.

The other extreme of investment probability, the “sure-thing”, is the basis of much of the credit troubles at several banks today. By contrast to the “lottery ticket”, the “sure-thing” bet pays very little, but is viewed as so highly probable that participants are comfortable borrowing, sometimes multiples of their original principal, to place the bet. Because leverage is required to earn significant returns, sure-thing investments can be even more dangerous than “lottery tickets” when they lack fair return for the risk (referred to in casinos as “true odds”).

\$99.9 million was bet this year on the Belmont Stakes, 32% more than in 2007 and the second highest in the history of the race.¹¹ The only Belmont with more money bet was in 2004 when Smarty Jones was an even higher 83% bettor’s choice following Kentucky Derby and Preakness wins.¹¹ No doubt, bettors placed more money on these races due the skimpy odds on the overwhelming favorites. You *have* to put up a lot of money on a sure-thing to substantiate the winnings.

Last quarter we discussed how Bear Stearns was finished by a sure-thing bet. Their sure-thing was Mortgage Backed Securities (MBS), which, in the AAA-rated category, had had a winning streak more impressive than Big Brown’s. The MBS asset class continues to trouble other banks, primarily Lehman Brothers, Merrill Lynch, UBS and Citibank.¹⁴

Sports fans and investors alike often act irrationally when tempted by extreme situations. In nature, sure-things are often not as sure as they seem. In the bond world the “risk premium” is the measure of how close a bond is to *the* sure-thing in terms of guaranteed principal repayment, the U.S. Treasury. One year ago, on June 12th, risky mid-junk-level bonds were yielding merely 2.4% more than Treasuries.¹⁵ Like the Belmont bettors, investors were treating risky bonds as if their principal repayment were relative sure-things. Moreover, they were borrowing money to make those investments pay more. As of April, the same spread was near 7%.¹⁵ Since recently being burned, banks and investors alike have turned risk-averse, overly fearful of investments at any risk level. Lessons in risk are learned the hard way. ●

Second Quarter 2008 Economy Review

The triple threat of higher oil prices, tighter credit markets and declining home prices still poses a significant headwind to the 2008 economy. Our index of leading indicators signals more economic slowdown.

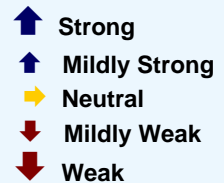
Furthermore, the Fed may have run out of ammunition, holding short-term interest rates steady after six straight rate cuts.¹⁶ Even the previously-strong developing nations have been feeling the squeeze of higher commodity prices and the U.S.-led global slowdown.



Leading Economic Indicator Summary

- **Market Cycle:** While calendar Q3’s (we label summers) on average do show market improvement, it is less than during other seasons.¹⁷ Since 1946, calendar Q3’s average only 5.9% annualized total return, versus Q1’s 15.0%, Q2’s 10.8% and Q4’s 20.7%.¹⁷ September, the final month of our upcoming quarter, is historically the worst month of the year for stocks. It is the only month that averages negative returns.¹⁷

Since September 18th short-term interest rates have been cut 3.25% by the Fed following the 0.25% cut April 30th. However, the Fed signaled on June 26th that they are now holding rates steady. Interest rate direction is the most significant short-term influence on stock prices.¹⁷ Market returns from 1955-2006 averaged 7.2% in the 12 months following rate increases compared to 18.5% following rate decreases.¹⁷



- ↑ **Political Cycle:** We are in 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.¹⁷ Since World War II, the fourth year of the presidential cycle has seen the S&P 500 Index post an average gain of 8.6%.¹⁷ Eleven of the 14 post-WW II fourth years have been positive.¹⁷ On average, the second and fourth quarters of a president's fourth year have been best, averaging 3.2% and 3.1% respectively.¹⁷
- ↓ **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. 1Q08 GDP was revised to have grown at 0.9%, following 4Q07 GDP growth of 0.6% annual rate, slow growth, but not yet in recession range.¹⁸ This represents the 26th consecutive quarter (six-and-a-half 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 continued its period of slight contraction initiated in December. The April reading was 48.6.¹⁹ While levels below 50 indicate contraction, in past recessions the ISM is usually lower, in the range of 43 – 44.²⁰
- ➔ **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. January – April the core CPI has averaged a tame 2.4%.²¹

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.²² This follows a 4.1% total CPI increase in 2007.²² Thus, with food and energy factored, inflation is running high.

What goods and services have increased the most over the last decade? Not surprisingly, education and medical care costs have increased the most, up 76% and 52% respectively in the last ten years.²³ Meanwhile, apparel and communication costs have actually declined.²³ Housing and food, the most basic of goods, have risen at a similar rate to inflation over the past decade.²³

- ↓ **Oil Price Control:** Oil prices actually rose \$11 on a single day this quarter, June 6th, approaching \$140/barrel for the first time. Oil prices have risen 43.3% thus far, midway through 2008, following a 47.5% increase in 2007.²

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 and hedged when necessary.

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 currently paying the price for underinvestment in oil production and refining throughout the 1980's and 1990's.²⁴

↓ **Consumer Spending:** We are beginning to see true, genuine weakness in the U.S. consumer. This is ominous since consumer spending represents two-thirds of U.S. GDP. The average U.S. consumer now spends 6% of his disposable income on gasoline.⁷

Total consumer spending spiked in May, rising 0.8% over the previous month, but much of this was due to the tax rebate checks and higher spending on gasoline.²⁵ When higher gasoline costs and inflation are factored, real spending actually declined.

Consumer confidence continued to plunge through 2Q08. The May Conference Board Index reached its lowest level in five years.²⁶ Then the June Conference Board Index fell to 50.4, the lowest level in 16 years.²⁷ The June University of Michigan Consumer Confidence poll fell to 53, its lowest reading ever.⁸

Monthly credit card payments have averaged five times the minimum over the last two years. In February it declined to 4.6 times, a sign that consumers may be struggling.²⁸

Finally, Moody's Investor Services is projecting 2008 to be the worst spending year since 1991.³¹

One positive factor is the technology and software sales growth to the citizens of developing and oil-rich nations who are rapidly increasing their wealth and desire for cell phones and computers.³⁰

↓ **Business Capital Spending:** Corporate profitability and balance sheets continue to show strength,³¹ 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.

CEO confidence is at a 5-year low, but CEO's are predicting higher sales partly due to strong overseas buying and a belief that the U.S. consumer will rebound and that the tax relief stimulus checks will help.²⁵

CFO's are even less optimistic. 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.³² The survey showed pessimists outweighing optimists 9 to 1.³³

↑ **Investor Sentiment:** The bull/bear ratio in the Investors Intelligence Survey turned decidedly bearish in June.³⁴ 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 flow into the market, especially with low interest rates making bonds an unattractive competitive investment.

Additionally, money market funds as a percentage of stock market value are near an all-time high.³⁵

➔ **Corporate Earnings:** Corporate profits of the Fortune 500 dropped in 2007 from the previous year for the first time in five years, suggesting that we could be in an official recession.¹⁵ However, earnings relative to their stock valuations are still excellent. As of June 20th, the P/E ratio of the S&P 500 companies was 21.2. Since 1990 the average has been 24.3. In this sense, stocks do not appear to be overvalued relative to historical norms.¹

↑ **Insider Trading:** Significant insider buying implies that managers have positive information about their company's outlook. Insider buying remained healthy with the 30-day moving average of buys in the \$30 to \$40 million/day range.³⁸

↓ **Merger and Acquisition Activity:** One major report indicated that venture capital transaction volume dropped 8.5% in 1Q08 over the previous quarter.³⁷ A second report showed volume dropping 7.0% and reported it to be at the lowest level since 2005.³⁸

The leveraged buyout (LBO) landscape has changed dramatically as the cost of capital to do risky deals has surged. Leveraged buyouts tend to be a bigger part of the deal flow when junk bond rates are low relative to corporate cash flows. That was the case from 2004 – 2007, but not now as risky lending has tightened.³⁹ And for good reason. 43% of the debt issued since 2003 is now distressed (defined as yielding 10% or more above Treasuries).³⁹ And the more recent the deal, the more likely it is to be distressed.³⁹ As of May, 75% of 2007 LBO issues were distressed and 48% of 2007 issues were distressed compared to 34% of 2004 deals which were distressed.³⁹ ●

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