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The year 2008 left many dubious records. Too many risky home loans followed by a steeply declining residential property market triggered a virtual freezing of credit during October and November. For these two months banks were not lending to individuals, corporations, or other banks. Victims included entities all along the credit chain from homeowners and credit card holders to some of the biggest financial institutions in the world: Bear Stearns, Lehman Brothers, Merrill Lynch, and Washington Mutual.

The S&P 500 Index finished 2008 with its worst quarter since 1974 and its worst year since 1931, down 37% (with dividends).¹ But what made this bear market especially painful was that none of the major asset classes, not even the “safe” ones, were spared. Most long-term stock investors understand that steep downturns are part of market cycles, but high-grade corporate and municipal bond holders expect stability. This economic turmoil, however, centered around large global banks, which provide the capital that fuels world economies. Simply speaking, banks sell loans, and loans are bonds. Once defaults started happening, institutions and investors became unwilling to give loans (or hold bonds). Like e.coli on a small percentage of spinach, most of the product was okay, but if you picked the wrong one, you could become quite ill. Banks did not know which other banks held the bad collateral and so would not lend, not even overnight to other banks.

Often, when stocks decline, bonds do well. In this case, however, bonds were the very thing causing the economic pain. Thus, many asset classes, which are normally safe and with little historical correlation to stocks, were also hammered. For example, in 2008 municipal bonds, high-grade corporate bonds, sovereign bonds, and commodities all were rocked along with stocks. The decline in stocks in 2008 was big, but relative to normal price movements, the decline in non-Treasury bonds was even bigger. Even money market funds and cash uninsured by the FDIC were not necessarily safe.

Through this turmoil, investors expressed incredible levels of fear. Last quarter we presented a detailed view of the various government programs and how we expect them to help in turning around first credit markets, then stock markets in 2009. This quarter we focus on the volatility that shook investors like an earthquake in 4Q08, and how it will form the basis for a strong 2009 in “Positive Returns Will Spring from Fear Factors”.

Financial Markets Summary

There was nowhere to hide in 2008 other than cash (stored properly in your mattress, not a bank). The majority of the year’s damage was done this quarter. In 4Q08 alone the S&P 500 Index fell 25% (with dividends factored), China fell 25%, Europe fell 30%, Oil fell 64%, REITs fell 41%, and high-yield bonds fell 20%.²



Hanging on in 4Q08 with some relative strength were preferreds (-4%) and high-quality bonds (+13%), which made something of a comeback right at year-end.² The iBoxx Goldman Sachs Bond Index, which Sharper ♦ Granite uses as a bond benchmark, snapped back (+10%) in 4Q08 to finish the year near even.

The average of all Sharper ♦ Granite client portfolios returned -15.0% (net of fees) for the quarter September 29th – December 31st. The risk level of the average of all Sharper ♦ Granite client portfolios was estimated to be approximately 44% less than that of the S&P 500 Index.³

For the year, the average of all Sharper ♦ Granite client portfolios returned -25.9% (net of fees) compared to the S&P 500 Index return of -37.0% (including dividends). ●

Positive Returns Will Spring from Fear Factors

With all the records being set to the downside and “black swans” flying around in 4Q08, perhaps the most remarkable event was the uncertainty and fear levels registering in the markets. Most of what we fear, whether it is the Boogey Man or a job change, is usually associated with the unknown. Fear in the markets is no different. Large uncertainty of economic projections drives large movements in investment asset prices. Greater price movements equate to greater risk.



Investment managers seek to achieve solid returns at acceptable risk levels. To gauge the risk component, we measure fear and uncertainty within the stock, bond, and options markets. Stock market volatility (risk) measures were so high this quarter that investors seemed to be predicting two nearly polar outcomes: either a recovery to normalcy in lending and in the economy, or a complete failure of the global banking system and economic depression. Three key fear/uncertainty factors flashed to levels never seen before in our history. We believe this fear is creating a base of opportunity for a strong 2009, albeit with a couple of pockets of danger.

Stock Market Movements

Most simply, one can measure daily movements in the major indexes. Going back to 1885, when the Dow Jones averages were first formulated, Sharper ♦ Granite, in conjunction with data from Professor Jeremy Siegel at the Wharton School of Business, identified 141 days when the closing Dow Jones Industrial Average changed by 5% or more – slightly more than once per year on average. However, in the 44-day trading stretch from September 29th through December 1st, 2008, we had 13 such days – almost one in every three trading sessions. Before then, the most recent 5% day was July 29, 2002.

Intra-day prices showed even more volatility. The S&P 500 Index swung an average 6.9% between its intra-day highs and lows last October and an average 5.4% intra-day range in November, making these the two most volatile months ever.⁴

Interestingly, there were actually an equal number of up trading days as down trading days in 2008. The average up day increased 1.6%, but the average down day decreased 1.9%.¹ Small percentages certainly add up over time.

The VIX

The Chicago Board Options Exchange Volatility Index (VIX) measures the implied volatility of S&P 500 Index options and can also be used as a fear gauge. Options are bets that the S&P 500 Index will move above or below a certain value within a certain time period. The main factor in the equation valuing options is market volatility. The VIX is quoted in terms of percentage points and translates, roughly, to the expected movement in the S&P 500 Index over the next 30-day

period, on an annualized basis.⁵ For example, if the VIX is at 15, this represents an expected *annualized* change of 15% over the next 30 days, or an *absolute* 4.3% change in the next 30 days. Index options are priced with the assumption that there is a 1- σ , or 68% chance, that the magnitude of the S&P 500's 30-day return will be within 4.3% (up or down).

In recent years a VIX reading of 30 was considered very high, a fear crescendo that often marked a bottom for stocks. In 4Q08 the VIX recorded a record 89.5, higher than any volatility during the Great Depression or Black Monday.⁶ VIX 89.5 implies that the market was pricing for a change in the stock market of 26% in the following month. The average stock market change for an entire *year* is around 12% and will fall within the range of -4% to +28% with 1- σ frequency, or 68% of the time. VIX 89.5 on a given day can be interpreted as a 5- σ event, or occurring once every 9,551 years.⁷

Treasury Bond Bubble

A third way to gauge fear is through the Treasury bond market. Shockingly, investors today are accepting 0% interest for 90-day Treasuries and 2.9% interest for 30-year, fixed-rate Treasuries. Investors are so afraid of losing money in any investment not explicitly backed by the U.S. Government that they are willing to accept extremely low rates of return.

With these three fear indicators at incredible extremes, we believe there are significant reasons for optimism in 2009. But first, note our warnings to the long-term investor for two asset classes in particular.

“The temptation to buy what has done well and sell what has done poorly is the single greatest pitfall in investing, and it is the single reason that a disciplined approach to asset allocation works very, very well.”

- Rob Arnott, Chairman of Research Affiliates and former editor of the prestigious *Financial Analysts Journal*

For short-term investors or those uncomfortable with stock market volatility, cash or short-term Treasuries are fine. For the long-term investor, however, holding cash or long-term Treasuries is risky. Regarding cash -- every academic study that has looked at the flow of dollars into and out of stocks has reached the same conclusion: in the aggregate, investors chase performance. They pull money out of markets at exactly the wrong time -- after a period of market declines.⁸ They invest in stocks after a period of increasing prices.

Remember, the highest return years frequently follow the worst years. Following the ten worst S&P 500 Index years, the average subsequent five-year annualized total return was 10.8%, with all ten five-year periods in positive territory. Furthermore, stocks typically begin their rise at the bottom of recessions.⁹ On average, 33% of bear market declines are recouped in the first forty days of the next bull market.¹⁰ Finally, cash is susceptible to inflation over long time periods. Thus, staying heavily in cash following a steep downturn is dangerous for long-term investors and can put their long-term portfolio projections at risk.

“Get out of Treasuries. They are very, very expensive.”

- Mohamad El-Erian, CEO of PIMCO, the largest U.S. institutional bond trader

Along with cash, Treasuries were a safe haven for investors in 2008. But beware, as mentioned in our previous *Fall, 2008* letter, Treasury prices have formed a bubble and a “safety trap” for conservative investors. The very investors who are most conservative or fearful are those most likely to buy long-term Treasuries for their perceived safety. But these

investors may be in danger. The recent rush to safety has made Treasuries very expensive, and thus, susceptible to a sharp decline. For example, if 30-year Treasury bonds move up in yield to just 4.35%, their yield last November 13th, then bond holders would register a 25% decline in value.¹¹

Given these warnings, we believe the widespread fear described above sets the backdrop for a positive 2009. Here are the four main reasons.

1 Unparalleled monetary stimulus coming from the Fed. Shock from the sub-prime mortgage collapse threatened the global financial system like no other event since the Great Depression. However, in contrast to the 1930's when the central bank provided no help to banks, the Fed has guaranteed 70% of all U.S. banking system deposits as well as commercial paper and has lent the banking system nearly \$1 trillion. Simultaneously, the Fed has lowered short-term interest rates to near 0%, and has coaxed the prime rate to 3.25%, and 30-year fixed (conforming) mortgages rates to 5% which should help stabilize home prices. When Japan's Fed, Bank of Japan, was faced with similar situation in the 1990's, they took a decade to impact interest rates to this magnitude. Even then, Japan avoided a depression.¹²

What about the impact of all this government spending? True, the Treasury's tab is enormous. In the first fiscal U.S. quarter the federal deficit was larger than any other *yearly* total as the Fed doubled its balance sheet in the last five months to \$2.2 trillion.¹³ However, the flip side to the Treasury bubble is that the U.S. Government may borrow from the world nearly interest-free for short-term loans and at about 3% for 30 year loans. Imagine if you could get a 30-year fixed mortgage at 3%. The money is being borrowed at such low rates that the debt interest is smaller than usual. Furthermore, the government is, in the case of the Troubled Asset Relief Program (TARP) and other programs, frequently getting assets in return. Those assets include equity in financial firms and preferred debt paying around 10% interest. Borrowing near 0% and making 10% is a great way to make money. Yes, if the major global banks fail, then the U.S taxpayer loses on the investments, but the U.S. government has indicated that it will not let that happen.

2 Fiscal stimulus coming from the President and Congress. President-elect Obama announced that he favors lowering tax-withholding rates by \$300 billion and implementing an \$850 billion infrastructure-heavy spending package.^{12, 14} Aid to state governments facing budget deficits is also likely. This will especially help municipal bonds.

3 Oil price decline coming from the global recession itself. The drop in oil prices from \$147 to \$40 is worth approximately 3% to GDP, acting as a tax cut for consumers.¹² Increasing oil prices have been a main concern of ours since "Oil, Our Most Important Commodity", *Spring 2004*. Oil is a key input to many business and consumer products. Its price movement can greatly affect consumers' ability to travel and purchase leisure-time products. It also impacts the profitability of corporations that produce plastics, fly airplanes, drive trains, build trucks or manage hotels.

4 Risk premiums. They went from bubble-like lows in 2006 where investors, greedy for yield, were accepting just slightly higher rates of return for junk bonds than for Treasuries. Today, that bubble is reversed. The yield between the 10-year Treasury and the average investment-grade corporate bond hit 5.7% in October and has come down only slightly since.¹⁵ High-yield bonds today produce a whopping 16% more interest than corresponding Treasuries, a spread up from 6% at the start of 2008 (see "High-yield Credit Bubble Bursts", *Fall, 2007*).¹⁶

Some worried investors are now betting significant chips on the end-of-the world scenario, a scenario which will not occur. This means opportunity is flashing for non-Treasury bonds, including high-quality corporate bonds, high-yield bonds, municipals, and preferreds. Investors of bank preferreds can be reassured that the U.S. government is investing along side. Most of the bank-directed TARP money has come in at the preferred level of debt.

Based on these factors, we believe the first ailment to recover will be the credit freeze. Banks are already showing signs of lending to consumers, businesses, and each other. This will be followed by the stock market hitting its bottom (this may have already occurred November 20th). Within several months of that point the U.S. GDP will turn positive, followed sometime later by the global economies. Housing market price declines will slow in magnitude, but actual widespread U.S. real estate price *increases* may be the final component to heal. ●

Fourth Quarter 2008 Economy Review

The National Bureau of Economic Research (NBER) declared a recession to have begun in December, 2007. This means that the recession is already longer than average. Economists are projecting it to continue two more quarters.¹⁷ One in six recessions historically was driven by a credit crunch, with one in four accompanied by a real estate bust.¹⁸ This is the first time that we have had both simultaneously. Thus, it makes sense that this recession is longer than average.



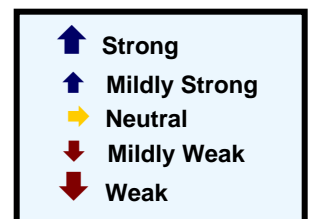
In response to the recession, the government has taken monetary action in the form of lowering the Fed Funds rate to 0 – 0.25% and providing \$3 trillion in various capital provision programs.¹⁹ Fiscal action is likely to come soon after Obama takes office in the form of tax cuts and rich spending programs.

Our leading indicators below portend more recession. Remember that the stock market consistently leads the economy by 5 – 6 months. That is, in the future looking back we should see that the stock market will have begun its next bull run 5 – 6 months after the NBER declared the recession end-point.¹² We believe the economy will likely see two more quarters of negative growth, with 1Q08 being severe and 2Q08 being closer to flat.

Leading Economic Indicator Summary

↑ **Market Cycle:** Looking forward, the first quarter of each year tends to be strong, powered by January which has been the third strongest of the months for the S&P 500 since World War II.²⁰

January is a good month but primarily for small caps and international stocks. Small caps have averaged 4.8% return in the month of January since 1925. In foreign countries January returns account for 30% of the total annual return on average.²⁰



➔ **Political Cycle:** We are moving into the first year of President Barack Obama's term. Traditionally, the first year in the presidential cycle is the weakest; however, first-year Democratic presidents have fared better. Since World War II, the first year of the presidential cycle has seen the S&P 500 Index post an average gain of 8.5% overall and 15.7% under Democratic presidents. When the data is reviewed stretching back to 1888, first years are still the worst performers, returning 7.4% overall and 7.3% for Democratic presidents.²⁰ However, the normal drivers of this phenomenon, post-election tough-medicine programs, will not be in play this time around.

- ↓ **GDP Growth:** Gross Domestic Product (GDP) is the official measure of the U.S. economy, tallying all goods and services produced in the United States. 3Q08 GDP fell 0.5%, following 2Q08 positive growth of 2.8%.²¹ One frequent definition of recession is two consecutive quarters of negative GDP. 4Q08 will likely be the second consecutive negative quarter. However, in this case the National Bureau of Economic Research (NBER), official judge of recession beginning and ending points, has declared this recession to have begun in December, 2007. Goldman Sachs is estimating GDP of -3.5% for 4Q08 and -2.0% for 1Q09.²²
- ↓ **Employment:** December was the twelfth straight month of non-farm payroll decline, taking the unemployment rate up to 7.2%.²³ 2.6 million jobs disappeared in 2008.²⁴ December was the twelfth consecutive month of job loss, a streak seen only three other times in the past 70 years.¹ In these three other long-duration cases, the recession was over before the job losses peaked.¹ Employment in many cases is a lagging indicator, which is why it normally does not appear in our Leading Economic Indicator Summary. When reviewing employment numbers, only weekly non-farm data should be observed to complete the economic picture, never the unemployment rate trend, which has political significance but is of little predictive value to economists.
- ↓ **Home Price Trends:** The Standard & Poor's/Case-Shiller Index signals an ending to the *increasing rate* of price decline.²⁵ That is, home prices are still falling but not as quickly. However, price declines in September worsened. In the San Francisco and Los Angeles regions, where most of our clients reside, the year-over-year decline reached 29% and 27% respectively, worse when adjusted for inflation.²⁵ A towering 11.2 month supply of unsold existing homes is still hanging over the market, driving continued price declines.²⁶
- ↓ **Purchasing and Manufacturing:** The Institute of Supply Management (ISM) Index, the key manufacturing indicator, continued to freefall this quarter. The ISM Index had been hanging on as one final indicator of economic strength until September, when it suddenly plunged to 43.5, its lowest reading in seven years.^{27, 28} Then, in December it fell to 32.4, the lowest level since 1980.^{27, 29} In the past, ISM readings of 43 – 44 generally occur during recessions.^{33S} We are now well below that level.³⁰
- ↑ **Inflation Control:** The most widely accepted measurement of inflation is the Consumer Price Index (CPI). The CPI plunged in the final six months of the year from a 5.6% annual rate-of-change in July to a -8.1% rate-of-change in December.^{23, 31} This made the total annual inflation for the year 0.1%, shockingly low and very close to deflation. The last deflationary year was 1955 based on Sharper ♦ Granite data.

Based on the strength of this recession, *deflation* is now a far greater concern to the Fed and the markets than *inflation*. While many worry that the money the government is pumping into the economy will eventually devalue the dollar, global economic weakness is far outweighing that effect in the near term. While battling a house on fire, you do not worry about the water damage.

Looking forward, the TIP-Treasury spread is 1.5% at 10 years and 1.7% at 30 years, indicating that the market is betting on *only 1.5% inflation average over the next 10 years and 1.7% average over the next 30 years*.¹²

- ↑ **Oil Price Control:** Recessions have many self-correcting features. One helpful characteristic of this recession is that oil prices have fallen significantly due to decreased demand. Oil prices are a proxy for the global economy. After rising approximately six-fold since 2001, oil prices fell 63% this quarter, following a 24% decline last quarter.² Oil hit \$147/barrel in June and fell to \$34/barrel in December, amounting to a huge tax break for businesses and gasoline consumers.³³

↓ **Consumer Spending:** We are witnessing true, genuine weakness in the U.S. consumer and a shift from a spending mentality to a saving mentality. Normally, this is healthy, but not in the middle of a recession. Consumer spending represents two-thirds of U.S. GDP.

Retail sales fell in through November for the fifth straight month and were down 7.4% year-over-year.³⁴ October same-store sales declined year-over-year at the fastest rate in eight years.²⁹ December was the worst holiday-shopping season since data was first collected in 1970.²⁴ Automaker pain was especially high as GM and Chrysler accepted billions in government loans to avoid bankruptcy at year-end. Auto sales overall fell to the slowest pace since February, 1983.²⁹

Goldman Sachs is forecasting a slight retail decline during 2009 of -0.5%.³⁵

After showing signs of a rebound in 3Q08, Conference Board consumer confidence fell below 40 to the lowest point on record, obliterating the previous all-time low of 53 set in June.³⁶ This may not be a bad thing because consumer confidence is not much of a leading indicator. Also, V-shaped, spike bottoms, which we may be forming, tend to correlate with GDP bottoms.¹

↓ **Business Capital Spending:** The tightening credit environment is especially threatening to businesses' ability to fund operations or invest in new products. Business IT spending especially is weakening.³⁷

↑ **Investor Sentiment:** The bull/bear ratios continued to turn more pessimistic through the quarter indicating that fear continued to permeate the market through December.³⁸ However, the first week of January showed a steep increase in sentiment, indicating that the trend may have been broken. We consider the current bearish level 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 back into the market. A yield of 0% on the ultimate safe investment, short-term Treasuries, verifies that investors are indeed fleeing every investment not explicitly backed by the U.S. government.

Additionally, money has been flying out of equity mutual funds and into money market funds, which are at all-time high levels.⁸ The ratio of cash to equities in the market surged to 31%, matching the level seen in 2002 after the tech bubble burst.³⁹ Huge mutual fund outflows like this are often bullish, marking bottoms as in 2002.

↓ **Corporate Earnings:** Corporate profits of the S&P 500 companies fell 16% in 1Q08, 22% in 2Q08, 12% in 3Q08, and are expected to bottom out and increase 29% in 4Q08 over the previous year.⁴⁰ These earnings continue to be dragged down by the disastrous financial institutions sector.

In each of the three past recessions – 1982, 1990, and 2001 – earnings fell 22% on average from peak to trough. Our plunge in this recession is already worse.⁴⁰

Based on earnings valuations, stocks do not appear overpriced. At current levels the S&P 500 is trading at a forward price/earnings ratio (P/E) of 13 times 2009 expected earnings, less than the historical average.⁴¹

↓ **Insider Trading:** Significant insider buying implies that managers have positive information about their company's outlook. In October, insider buying was trending up, averaging about \$35 million/day. By year-end however, insider buying had trailed off to just \$10 million/day, the lowest point of the year.⁴²

↓ **Merger and Acquisition Activity:** M&A activity has fallen sharply. Private equity funds raised the lowest amount of capital since 1Q05.⁴⁴ September was the first month since April, 2003, without a single U.S. IPO.⁴⁵ Venture capital investments dropped 7% in dollar value and 14% in number of deals from the previous quarter.⁴⁶ ●

Notes and Acknowledgements:

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2. Indexes used: Barclay's S&P Europe (IEV), Vanguard's REIT Index (VNQ), Barclay's US Preferred Index (PFF), State Street's Lehman Index (JNK), Barclay's Morgan Stanley Hong Kong Index (EWH), Barclay's Goldman Sachs Oil Index (OIL)
3. Global Investment Performance Standard's (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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