

February 24, 2009

Dear Client:

These troubled times compel me to take up the pen and share my thoughts with you. Although some have spoken with me, I want all of you to be aware of where we stand now and, with an abundance of humility, our outlook. The swiftness and severity of the current stock market decline is now unprecedented.

Much ink has already been spilled over the causes, but a few factors need emphasis. Many of us had been concerned for some time over the reckless lending, the large debt-financed trade imbalance, and the development of an unregulated "shadow" banking system. In 2004, Henry Paulson, then CEO of Goldman Sachs, led a delegation of Wall Street investment bankers to Washington to meet with the SEC. They successfully convinced the agency to repeal rules which governed the amount of debt which their holding companies could maintain. As a result, our largest investment banks morphed into highly leveraged hedge funds. At the same time, the largest commercial banks that traditionally originated and held loans as their predominant asset were adding investment securities, such that by the end of 2007, these securities just about equaled the loans they held. We arrived at the point where we had a dangerously fragile financial structure but the commercial world still functioned well.

By September of 2008, it was clear that the financial sector had begun the task of correcting these excesses. The fall of Lehman Brothers caused a panic among our government officials; President Bush, Secretary Paulson, and Fed Chairman Ben Bernanke went before the world and proclaimed their fears and urged passage of a poorly thought out proposal we know as TARP. From this point on, a paralyzing fear enveloped the entire business world. It became clear that an ongoing recession would turn much deeper as both financial institutions and commercial enterprises hoarded cash and deferred investments and spending.

President Obama's crew has not helped matters with some early confidence-sapping actions of their own. The net effect has been to deter financial investment. Strikingly, the communist Chinese government has stood out among major countries with policies appropriate to its own situation.

What has been Spectrum's response to these events? This business requires humbleness about predictions and the record of market timing is poor for investors. Thus we have tried to maintain our discipline, although emotionally it might have sometimes seemed easier to get out of the way of this storm. Certainly as I write after another 6.2% decline last week, it would have been nice to do in the short run. Nevertheless, our conservative asset allocation has meant that the damage has been less for you than for most investors. The ability to ride out this storm may result in some important benefits for you.

The first upward move following a bear market is usually rapid and large. It is also indistinguishable from the sharp bear market rallies which have punctuated both this and other bear markets. The present phase of the decline has been indiscriminate. The stock market was in a similar state when I first began to manage money in the 1970's. We have a once-in-a-generation opportunity to purchase the finest companies in the world at prices usually reserved for the more ordinary. While we will be occasionally opportunistic and purchase special situations or bargains, the equity strategy will be to continue to purchase quality stocks when they go to large discounts to their true worth. Because these companies possess businesses of sustainable profitability and proven management depth, they should be outstanding investments when the fear and selling subside.

As always, too many are extrapolating the recent past too far into the future. Certainly the missteps of the government and the irresponsibility of certain business leaders have discouraged all of us. Winston Churchill once said he admired Americans because they always did the right thing, but only after they had exhausted the other options. My concerns for the long term include a resurgence of inflation. In addition, the need to pay off debts in U.S. dollars has created somewhat artificial strength in our currency. Once the financial crisis subsides, the inflationary factors at work will probably result in the dollar's weakness, and we will take further steps to take advantage of such weakness. In the face of these future challenges, the minimal yield on cash seems unlikely to assure financial security over the intermediate or longer term.

You may have observed the large number of hedge fund managers who risked their clients' assets with highly leveraged strategies which rewarded them well. Now that their excess compensation is gone, they have shuttered their funds and abandoned their clients. I want to assure you that our commitment to our clients' financial health has never been stronger. We will do the best work possible in this storm and see you through it.

Thank you for your patience and understanding during this difficult time.

Sincerely,

Marc Heilweil