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From the desk of Eric Barden – Chief Investment Strategist

October 13, 2008

Quality stocks are priced for a disaster that we think is unlikely to occur. As of Monday, the world's finance leaders have agreed to a coordinated plan of attack that should restore confidence in the global banking system.

The market decline accelerated from a typical bear market to something that more resembles a panic. The last 9 market days have seen a 25% decline. That's only happened twice in S&P data history... during the crash periods of 1987 and 1929. In both instances, the stock market was higher at 1wk, 1mo, 3mo, and 6mo later. In fact, the 6-month gains were 15% and 21% respectively.

What the heck is going on?

In a nutshell, a bad situation got a lot worse when Lehman Brothers failed. They owed a lot to money market funds and the failure to pay off these loans led to a run on the money markets. Money market funds provide the short-term funding to operate many global businesses. Short-term money is the oxygen of capitalism. That oxygen was cut off. The only functioning market where these companies could sell assets to fund their operations is the stock market. That has caused the breathtaking declines that we have seen recently.

At last week's low the S&P 500 was down 46% off its highs from October '07. In comparison, the Banking Panic of 1907 saw declines of 37%; the WWII bear market from 1939-1942, encompassing Pearl Harbor drove markets down 39%; The 2000-02 tech stock crash led to losses of roughly 50%, similar to the losses suffered in 1974-75. Empirically, this is about as bad as it gets. I find that to be a reason for optimism. I'm hopeful that once authorities are able to get the short-term credit markets functioning again, we will see a very sharp rally.

So, what's it going to take to get credit markets functioning? That's the \$64 trillion question. The Fed is essentially setting up a parallel banking system through the major central banks around the world. They have also for the first time in history, coordinated a simultaneous interest rate cut. The central banks have the ability to lend money directly to firms that are suffocating from a lack of funding. There have been roughly 10 unique facilities created by central banks in the last few months. Eventually, they will

work, but until then the stock market has been the only source of cash for these distressed lenders.

Bottom line is we are much closer to the end of this than the beginning. My best guess is that the market crash will run its course; the margin call on hedge funds will cause many funds to liquidate, leaving prices at almost unheard of levels below intrinsic value. The market will stabilize, and the ten or so new Federal Reserve programs will begin to kick in, leading to a super sharp and fast rally that could be as great as 50-60%.

In this kind of market, investors with a long time frame and low leverage are in a position of strength. We have the ability to take advantage of hedge funds that are receiving daily margin calls. Leveraged investors are forced to sell their shares at whatever price exists in the market. They are in foreclosure. Investors with cash and an eye for value can pick up some of the best values that we'll ever see.

According to Longleaf Advisers, highly respected value investors, there have been five instances of value stocks dropping two years in a row: the depression, world war II, the early 70s oil embargo, the aftermath of the tech stock bubble, and now the credit crisis. The average twelve month return after each of these past periods is 60%. According to Longleaf, price to intrinsic value ratios are the most attractive they've been in 40 years.

The market is trading at valuations that suggest a very severe economic contraction. A CNN poll that I saw today suggested that 60% of the population thinks a depression is likely. Marketwatch's Chief Economist Irwin Kellner suggests that this crisis does not compare to the Great Depression:

- The jobless rate jumped to 25% by 1933; it is little more than 6% today.
- The gross domestic product shrank by 25% during the early 1930s; it is up over 3% during the past year.
- Consumer prices fell by about 30% from 1929 to 1933; and the last time I looked they were still rising.
- Home prices dropped more than 30% during the Depression vs. about 16% today.
- Some 40% of all mortgages were delinquent by 1934 compared with 4% today.
- In the 1930s, more than 9,000 banks failed compared with fewer than 20 over the past couple of years.

Remember also it was policy errors, not the stock market crash, that caused the Great Depression:

- Instead of increasing the money supply, the Federal Reserve of that era reduced it by one-third.
- Instead of lowering taxes, Herbert Hoover raised them.
- And to channel whatever demand was left into U.S.-made goods, the government enacted the Smoot-Hawley Tariff Act to keep out foreign products; this only provoked our trading partners to do the same.

Add to this today's automatic stabilizers such as unemployment insurance and Social Security, the FDIC to insure bank deposits and circuit breakers to keep stocks from falling too quickly, and you can see why this is not a depression in any way shape or form.

Academics have been studying the causes and policy mistakes that led to the Great Depression for more than 60 years. Chairman Ben Bernanke is a leader in this field of research. If the main question is whether we are heading into a Great Depression like disaster, it's only fair that we describe the tools that the good guys have to keep us out of it. As of today, we have the following:

- \$700 billion purchase of distressed illiquid securities, to be managed by outside asset managers (like a typical pension)
- Extraordinary pace of financial industry restructuring
- Central Banks are acting as lender of last resort for short-term money markets
- Government guarantee of deposits
- Emerging markets have vast dollar reserves
- Oil price stabilization
- Likely to see coordinated interest rate cuts.
- Direct purchase of banks in order to ensure adequate capitalization

Right now, we have two choices. We can bet on recovery, or we can bet on financial debacle. The government agencies are not sitting on their hands. This increases the likelihood that we will not suffer to the same extent as in the Depression. According to the Wall Street Journal,

Eugene White, an economics professor at Rutgers University who is an expert on the crash of 1929 and its aftermath, thinks that the only real similarity between today's climate and the Great Depression is that, once again, "the market is moving on fear, not facts." As bumbling as its response so far may seem, the government's actions in 2008 are "way different" from the hands-off mentality of the Hoover administration and the rigid detachment of the Federal Reserve in 1929 through 1932. "Policymakers are making much wiser decisions," says Prof. White, "and we are moving in the right direction."

The economy will definitely stay weak for a while. The new consensus is four more quarters of negative growth and unemployment pushing 8% from 6.1% today. Sentiment and valuations seem to be discounting a much worse slowdown than that.

From an investment standpoint, it's probably too late to seek the safe haven of cash. Safety currently pays .07%. I could write pages of valuation analysis that point to valuations being absurdly attractive today. The money is out there, but it is confidence that is lacking. But, as interest rates decrease, the profitability of lending increases. Banks with capital to lend will benefit from higher profit margins and earnings will turn dramatically higher. I am convinced that we are approaching one of the best buying opportunities this decade.

These are terrifying times. But I am convinced that it is these times when we are most rewarded for investing with our heads.

We've been through difficult times before. James Stack at Investech provided the following headlines for comparison:

Recession Starts Taking Toll: Will it lead to another crash? "Worries are building that today's sagging economy may be on the brink of collapse."

U.S. News & World Report

Running Short of Cash

“The United States and its allies scramble to head off a global financial disaster... finance ministers from the United States, Britain, France, Japan and West Germany met last week near Frankfurt to find a way to avert a global economic collapse.”

Newsweek

These headlines are not from today, but from November 1974 and December 1982... at the very depths of their respective bear markets. In each of those past fearful periods, the financial world did not come to an end – not in 1974, or in 1982, or after the 1987 Crash when everyone believed another depression was imminent.

Even though it's not entirely clear how we're going to muddle through this mess, history suggests that we always find a way to do so.

Thank you for your continued business and trust. We hope to continue to reward the confidence you have in us.

Sincerely,



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Enclosures