

1st Quarter
Investment
Strategy
Report

March 31

2009

"Beware of little expenses; a small leak will sink a great ship."

Benjamin Franklin

A.L. WATERS CAPITAL LLC

General Outlook

In our view, it will be an Eight Quarter evolution before we return to normal. Our fearless leader, Arnie (one must remain fearless in the world of money management), pointed out to us after a recent trip to McDonald's (and we hope wife Janet doesn't hear about it), that the crew was populated only by adult workers as opposed to the usual multitude of barely legal teens. This is remarkable because it surely reflects on the true desperation of the matter. Along this point, we are concerned with how the length and severity of the economic collapse will change consumer spending. We are also concerned whether the changing habits will become generational. High profit margin spending does not occur at Wal-Mart but at Tiffany's and Harrods and the like. If one has five cashmere sweaters from Ralph Lauren, how many do you really need? How many American's will be driving within the US for their vacations instead of flying to overseas destinations, or to the far reaching parts of the US like Alaska or Hawaii? Your faithful observer Arnie, an avid fly fisherman, already noted that not only has Orvis has been forced to lay off people but virtually all destinations in the American west and Alaska are offering significant discounts. The question will be, given the number of affluent outdoorsman, how much more significant losses will there be in outdoor travel to Montana, Nebraska, Idaho and elsewhere. The roadside is full of signs of change stemming from the economic crisis. In storefront windows

you may see "Recession Special" or other deals that speak clearly to the mindset of the consumer. In our view, there will be no improvement for another twenty four months or so. The question remains: How much of a change will there be in affluent consumer spending? A sea change is underway. In addition, much active growth in the US comes from companies with less than 500 employees and spending among the ownership class is expecting substantial deductions in office furniture, IT systems, and the like. The current crisis will continue to have an accumulative effect on portions of society that few have even considered yet. Our understanding of the capitalism, as we knew it, may be changed forever.

In light of the considerable turmoil in all things financial over the past several months, it is so important to re-state our macro-economic view, and to revisit where we are and where we should be in terms of our projections.

Our Gold View:

Total demand for gold, contrary to some perceptions, was up 4% in 2008 over the previous year. A strong second half of the year, underpinned by an increase in net investment, more than made up for weakness in jewelry and industrial demand. Over the course of 2008, gold's average price was \$871.96 which was up 25% from the average in 2007. Identifiable investment demand for the precious metal was up 182% YOY. Bar and coin shortages were reported across the globe as investors sought some way to participate in the gold arena. The most dramatic increase was in

Europe where bar and coin demand surged from 9 tons to 113.7 tons YOY.

On the supply side, YOY production declined by 3% with the most significant reductions coming from South Africa and Australia. Power supply issues forced several closings in South African mining operations while several Australian projects were scrapped after disappointing results. These declines were offset to some extent by increased production in Russia and Indonesia. Finally, net selling by Central Banks has been relatively mild, thus adding further support to market prices.



While gold has experienced some relative volatility in the past two quarters, the general trend has been undeniably higher. The worsening economic environment and uncertainty in the broader market has created a rejuvenated awareness of gold as a mature asset class. A common sense view of the printing press economics that has been heralded as sound policy during the financial crisis would lead even an arm-chair economist to fear the consequences. The Federal Reserve has promised to withdraw

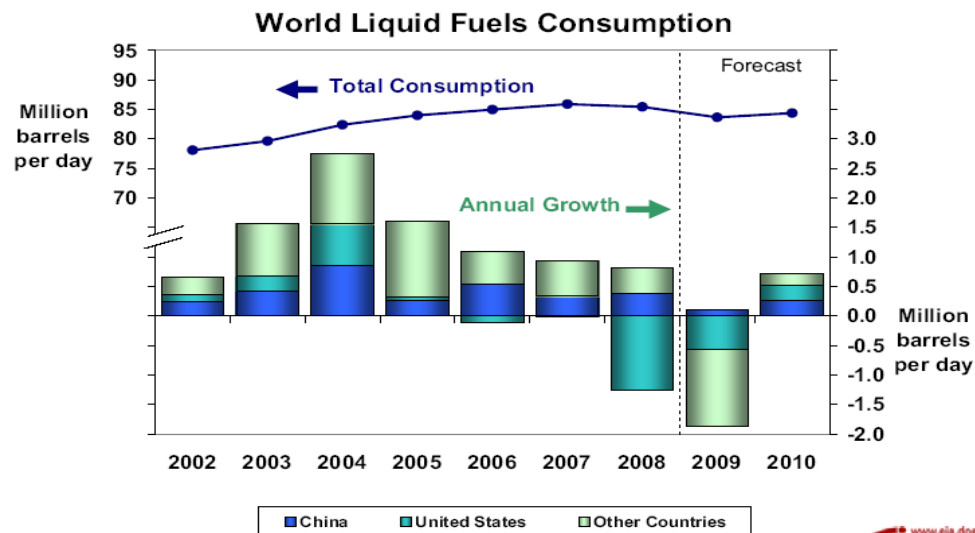
excess liquidity from the market at the earliest signs of stabilization, but we all know that inflation is much harder to avoid than to stop once it becomes a problem. It's quite similar to stopping a running bull as it charges by you in the streets of Pamplona. Your last chance comes before you open the gate. Investors, as a result, have been quietly accumulating positions in gold as a hedge against what could become the next big crisis: a monetary collapse.

Looking at the long term chart of gold prices, the volatility is a little less discouraging considering what an S&P chart would look like over this same time period. Compared to other investment vehicles, gold has held up exceptionally well in light of the economic turmoil. Looking specifically at the past three years, we believe that we are at, or very near, the bottom of a cycle where gold will begin a move toward new highs over the next two quarters. We believe that our long view of gold at \$1500 is a conservative estimate.

Our Crude View:

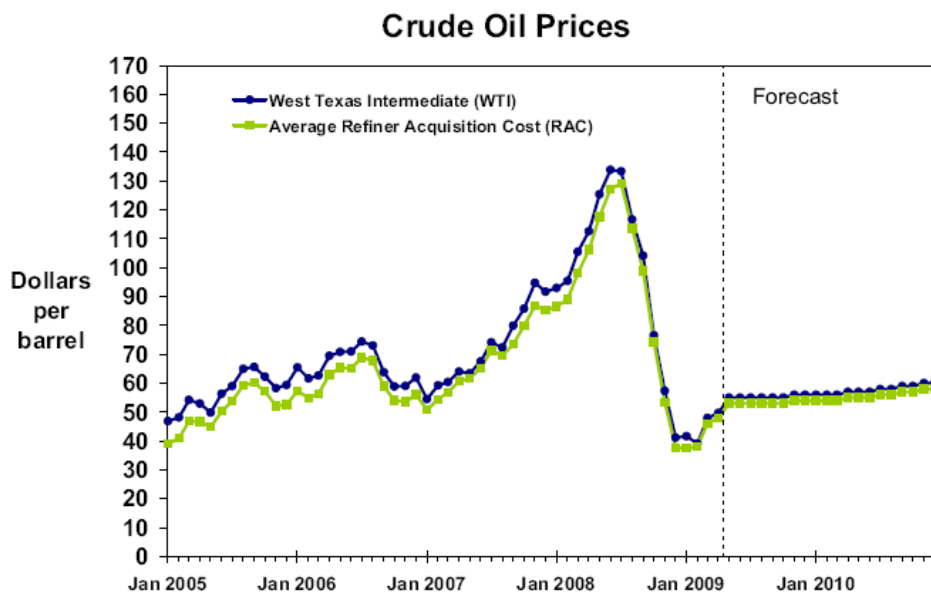
A fair analysis of the oil market is a little more complicated than the case for gold. If gold was seen strictly as an industrial commodity, we would be more bearish due to our dire economic view. Such is the case with oil where several factors supporting a rise in crude prices are offset by our concerns that demand could fall further. When oil tumbled to below \$40 a barrel, we soon after issued our forecast that

prices would work their way back to a range of \$60-\$70 and then level off for the rest of 2009. Even that position would be considered bullish when compared to the Energy Information Administration's forecast for a flat performance close to \$55 a barrel throughout this year and only a \$58 average for 2010. The EIA lowered its forecast from the prior month's assessment as "expectations of global economic recovery and a resultant increase in demand were offset by initial data for the first quarter showing high oil inventories, weak consumption, and higher-than-expected production." World consumption is now forecast to fall by 1.8 Million barrels per day. An expected increase in consumption is predicted for the Middle East, China, and India but this will be offset by a strong decrease coming from Asia and the States of the Former Soviet Union.

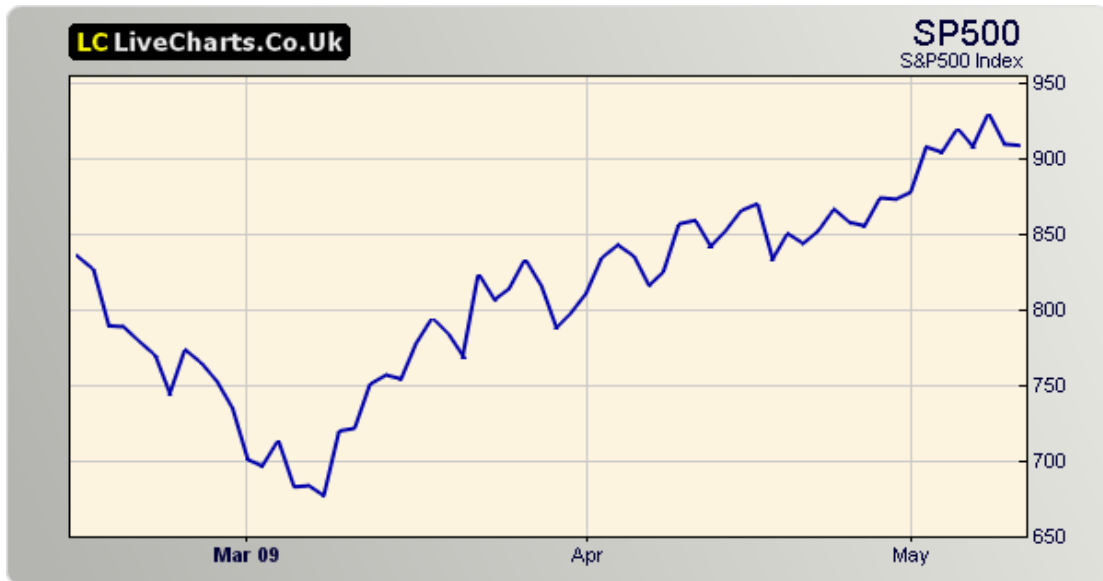


In its ever present desire to be forward looking, Wall Street has begun to price in some levels of artificial demand

based on growing optimism that the world economy may be showing early signs of recovery. Our generally more pessimistic view of the economy and of the banking system leads us to believe that the present level of optimism may be too much, too soon. We expect to see another wave of losses for the big banks coming from commercial real estate exposure and the resultant economic consequences. In addition, the housing market has not yet bottomed completely and the jobless rate stands to surpass current expectations. As the final kinks are worked out of the economic system, the stock market could be in for another leg down, perhaps below its recent lows. Simply put, with our concern for further erosion of demand as the economy falters keeps our bullish nature in check. We still see oil reaching our target of \$70 based on superfluous optimism on the Street, but beyond this quarter we could also see a return to the \$40 range.



Market View



Calls for a V-Shaped recovery are based more on wishful thinking than sound principle. In the middle of the Great Depression, early warning signs suggested recovery was looming and this led investors and policymakers alike to let their guard down. Looking at patterns in the stock market from the Great Depression, to other dramatic bear markets, a V-shaped reversal has always proven to be a fool's bet. History is filled with very smart and talented people that have made regrettable choices and statements.

To remind you of a few to ponder:

1. "We will not have any more crashes in our time."
- John Maynard Keynes in 1927
2. "There may be a recession in stock prices, but not anything in the nature of a crash."
- Irving Fisher, leading U.S. economist, New York Times, Sept. 5, 1929
3. "The end of the decline of the Stock Market will probably not be long, only a few more days at most."

- Irving Fisher, Professor of Economics at Yale University, November 14, 1929
- 4. "...there are indications that the severest phase of the recession is over..."
 - Harvard Economic Society (HES) Jan 18, 1930
- 5. "Gentleman, you have come sixty days too late. The depression is over."
 - Herbert Hoover, responding to a delegation requesting a public works program to help speed the recovery, June 1930
- 6. "We are now near the end of the declining phase of the depression."
 - HES Nov 15, 1930

So we remain cautious for now. There are opportunities at all points of the market cycle, but to be swept away in a sea of optimism while so many factors remain unresolved is unwise. The banks will face considerable write downs from their exposure to Commercial Real Estate, which has not really been accounted for in the recent stress tests. In Detroit, we will see a considerable ripple effect from plant shutdowns as the parts suppliers and shippers deal with the sudden vacuum left behind. All this, and an unemployment rate that many see reaching higher by another 2-3% before its peak. A dramatic and lasting change in the financial landscape has occurred. Indeed it has rapidly turned into a cultural shift as well. There is a witch hunt mentality brewing that will put a damper on bold thinking. The restrained atmosphere on Wall Street has created the need for a new mindset among money managers. A paradigm shift has occurred that will bring a new awareness to so-called value stocks and those with a strong and steady dividend yield. We have always had a fondness for the Royalty Trusts that hold rights to property and production in the energy sector. It is important to

look for a consistent dividend distribution and to avoid aging trusts that may be nearing an exhaustion of proven reserves. It is also of primary importance to observe the volatility of the price action on shares. It is self defeating to pick up shares in a trust where a high yield will be negated by capital losses on the open market. Some Royalty Trusts will show a yield of 13-15% but some of the more stable may yield 6-10%. As a comparison, BP Prudhoe Bay Royalty Trust (BPT) carries a yield just under 6% but has shown price stability with a beta of .54. By contrast, Tel Offshore Trust (TELOZ) offers a 34% yield but has fallen from over \$42 per share to a low of under \$4 in the past year.

Despite many calls from friends and clients when the banking stocks began climbing, we did not, and will not soon, recommend buying in to this sector. Exposure to commercial real estate will be the next round of despair facing the largest institutions. Until then, it is simply too risky to assume the worst is behind the financial sector.

To review some of the key levels we will expect to see before a light appears on the horizon:

- ✓ Unemployment rate above 10%
- ✓ National Average Home Price decline of 25-30%
- ✓ Average P/E multiples for the S&P at 9-10x

These are just a portion of what we have anticipated right from the start. We aren't far off from these levels compared to where we were when we first issued our forecasts. In terms of the stock market, we expect to see a retesting of the previous lows near 6500 on the Dow.

