

3rd Quarter Investment Strategy Report

A.L. Waters Capital, LLC

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*"Capitalism without bankruptcy is like Christianity without hell."
-Frank Borman, former CEO of Eastern Airlines*

2008

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Overview:

To say the markets have become reckless during the 3rd quarter of 2008 would be an understatement. We have been able to experience a once in a lifetime event at the detriment of those near or currently in retirement. There has been much to be learned during 2008 for the future of the portfolio management industry. We have stated that patience would be required to get through this recession. This has never been so important. If you would have hedged positions to market neutral and obtained large cash holdings in early to mid 2008, your portfolio would be in a great position to outperform its benchmark. We have focused on trades that minimize market risk and maximum potential loss while maintaining a significant percentage of cash.

“Capitalism without bankruptcy is like Christianity without hell” is one of the themes we have chosen for this quarterly report. Once you can understand the functionalities behind capitalism, you understand that what is going on in the markets is necessary. Free markets, free enterprise, and private property are at the forefront of capitalism. However, the goal of capitalism is not a factor such as one of these, but rather a goal of the system. This is competition and the resulting maximum efficiency economy. The question now becomes how this relates to the present day situation. As we have seen, one of the causes of the current recession was the lack of risk management at the major banks. The financial industry became significantly leveraged to maximize returns, while not accounting for the risk/reward. Fannie Mae and Freddie Mac took advantage of their implicit government backing by taking on unnecessary risks assuming worst case scenario would be a bailout. All of this was going on in the collateralized mortgage obligation market. Banks could repackage loans from Fannie and Freddie and sell off different risk levels at different tranches. However, the next bank that purchased these securities could then repackage them again and sell their own security. If you can imagine this happening several times over to the point that the final buyer of the derivative security really does not know what type of risk exposure he or she has or where the original cash flows are based, then you can understand the situation in the financial sector. This massive sell-off of financial stocks, both closing positions and opening short positions, has stemmed from investors not knowing what exposures any given bank truly has. A small regional bank that purchased CMO's from Wells Fargo may not realize that navigating back to the original mortgages may result in a path that went through Lehman Brothers, Bear Sterns, and Merrill

Lynch. This is an example of how investors don't know what banks had ties to Lehman or Bear Sterns, or any other institution that is losing solvency. Because of this, the short trade on financials has worked and will continue to work until transparency around their financial statements, off-balance sheet special purpose entity exposure, and cash solvency situation is resolved. Perhaps the major cash infusion by the Fed through the purchase of some of these unclear derivative securities will help to solve two of the problems. We arrive back to the point about capitalism. Survival of the fittest is an inevitable characteristic of a capitalist environment. We are witnessing the markets breaking down company by company until we are left with the best and most protected. Financial institutions that acquired more risk than they should have are getting punished, and it becomes a very competitive environment to make it to the end of this recession. This has been the catalyst for a breakdown of the rest of the market. Companies who have not strived to be the most efficient and competitive will now be exposed as the tide pulls back. In the end, this puts our portfolio in a very good position to identify these companies who are best of breed and purchase them at attractive valuations. We couldn't be in a better situation. Again once you truly understand the theme from our cover page quote, you realize that it is necessary for the markets to strain through our economy and weed out poorly managed and inefficient businesses. The economy only becomes stronger when it emerges. There is a similar thought about pain and pleasure. You may have heard that without pain, there is no pleasure. This is absolutely true and will be evident when the global economy picks up once again.

The "Bailout":

What is a bailout? Is Treasurer Secretary Paulson's Troubled Asset Relief Program a true "bailout"? Well, technically, one can consider a bailout a situation where the government injects capital into a firm that is on the brink of bankruptcy, in the hope of continuing business and sustaining stability. At first glance, it is difficult to determine if TARP is truly what we think it is. Taking a look at the details, we find that TARP proposes to set up an office within the U.S. Department of the Treasury that will use government capital to repurchase mortgage-related assets and other troubled assets from lender's balance sheets that are then transferred to the Fed's balance sheet. The original plan was to commence in waves of \$250 billion, followed by another \$100 billion to be approved by the President, and yet another \$350 billion to be approved by the President with the possibility to be revoked if Congress so chooses. Two more pieces to the plan include providing liquidity for short-term paper as well as expanding the list for assets used as collateral in order to stimulate the market. Buying mortgage-related assets from lenders may not be considered to be a bailout, though. It is a market transaction exchanging capital for assets, some or most of which can retain value over the long-term. We know default rates are rising, but we also know the chance of \$700 billion in mortgage-related

assets being worth nothing is highly unlikely. Also, we find many people claiming that taxpayers are on the hook and criticize a plan such as this. What these people may not have realized lies in some of the details of the plan. In order to protect taxpayers, the plan proposes three solutions. First, any future revenues from the sales of the purchased troubled assets will be used to pay down national debt. Second, losses incurred by TARP will first be attempted to be recovered from the financial industry. Finally, and most importantly, the Treasury will receive warrants on these institutions in order to receive equity gains in the case of recovery. We view this last taxpayer protection as most valuable. TARP is not as detailed as we would like it to be, and thus many analysts are unable to make assumptions going forward, but with long-term warrants on financial stocks, the Treasury could be in a situation to earn significant gains. As long as these gains are offset against losses on assets, this should help to reduce taxpayer risk, granted this will take time.

So what is it that has changed the dynamic of TARP? Well as we have discussed, it is not so clear that TARP was originally a bailout. Of course it depends on who you ask. However, Secretary Paulson has recently thrown a curveball with the capital from the program. He has been able to purchase equity stakes in these financial institutions using the first \$250 billion from the plan. This proved to be a shock to those who were familiar with TARP, as there was no evidence of such a move in the original plan. With the Treasury's stake in AIG rising over \$100 billion, the dynamic of TARP has changed. It is difficult to determine which strategy would be more successful because of the lack of historical data. Some were looking for that stability in mortgage-related asset prices, which has now adjusted to ownership stakes in our banks. The injection of capital into the banks for equity stakes has a more similar character to that of a bailout. Although not quite the free injection of capital, it remains that the success of this "bailout" will only be determined over time. We need to purge our capitalist system of the weak and less competitive. Then we will see how long a government stake and intervention lasts, hopefully not *too* long.

Strategy:

It has been our view for quite some time now that the U.S. economy and those abroad are in serious financial distress and have been in a global recessionary environment for 2008. However, determining an economic situation and predicting a poor global economy can be significantly different than predicting market prices. For instance, during the 1st and 2nd quarters of 2008, we were confident that our \$1,200 price target on the S&P 500 would be reached during the 3rd quarter. While the target hit, the breakthrough below various support levels has caused the markets to plummet in value over such a short time frame. Surely no one could have expected an \$850 S&P 500 during October. This has raised much concern on our

end. We believe that securities markets do not accurately reflect ALL information. Those who believe in perfect, efficient markets assume passive investment strategies to mimic market returns. This financial turmoil should be used as evidence that perfect markets are not the case. Wild swings in the S&P are the result of uncertainty and both rational and irrational behavior. It is rational because the downtrend does represent the growing global concerns. The shape of the global economy and uncertainty about some of the most trusted institutions warrants these drastically low prices. However, the uncertainty combined with irrational behavior is what is driving the extreme volatility. Recently the most bullish analyst on the S&P 500 changed his price estimate for the index from the highest by year end to now the lowest by year end, making him the most bearish. If anything, this is the most obvious case of uncertainty. Drastic behavior such as this adds to irrationality in the markets. Not too long ago Ben Bernanke was claiming the worst of the financial crisis seemed to have passed and the turmoil eased. Perhaps circumstances such as the two mentioned above have added to the problem.

We are not going out on a limb here, and we have said this in the past, but our primary strategy going forward will be to have patience. With the breakdown in the financial markets, and the weakness on Main Street, no one is jumping back into risky securities (i.e. any securities besides treasuries). Patience means that we want to see the markets stabilize before any large bets are placed. We want volume to slow and volatility to fall. The situation does not give us the opportunity to make any rational predictions about the direction of the market. Certainly we can claim that the S&P 500 will be higher than it is now 10 years from now, but that doesn't do us any good if we have to withstand another sharp drop in equities. Therefore, when the time is right, when we believe in a strong probability in one way or the other, we will be willing to make predictions. As for now we do not see probabilities leaning to one way or the other, to a breakdown below support or to a sharp rally. The risk/reward scenario is unique in history, as is the economic situation; however, large cash positions remain optimal. Also core positions should be entered into in small increments at these low prices to capture some of that value. We will discuss our strategic technique in the following.

Market Neutral Trading

A Market Neutral trading strategy is most logical over the next couple quarters as market risk premiums rise. The strategy aims to reduce the impact of market risk on positions and allow for the manager's skill of identifying strong and weak peers in an industry. We believe this type of trading will reduce volatility over the coming quarters. It allows us to take advantage of mispricing or exaggerated valuation differences between our top picks for given industries and their weaker competitors. By buying our top picks, and subsequently shorting the weaker peers, we will reduce market risk and capture only the outperformance of the

stronger. We have been analyzing trends between competitors and backtesting various trades. We will look further to identify the greatest risk/reward scenarios as well as the largest mispricings. Finally, it will be important to note that a beta-neutral strategy is optimal to satisfy the differences in volatilities of two positions. A Pairs Trade using beta-neutral versus dollar-neutral weights attempts to further reduce volatility and adjust for risk differences.

Conclusion:

In all fairness, we did not decide to discuss specific industries that are doing well or poised to do well. This is simply because our current strategy of market neutral does not require us to be correct as to the direction of an industry. We have seen too many sad stories this year surrounding the hedge fund industry. It is better to not get caught catching the falling dagger than to plunge with the rest of them. Volatility is too extreme, and with the mark-to-market process, there have been too many cases of covering positions for large realized losses. With the new Democratic regime in power, political risks have risen as to the future regulation of the hedge fund industry. Some hedge fund managers recently convened with Congress and seemed split on their opinions of more regulation or deregulation. George Soros warned that too much regulation could heighten the problems. While Jim Simons of Renaissance Technologies proposed for more transparency but keeping the information private. Other managers present included Ken Griffin of Citadel, Philip Falcone of Harbinger, and John Paulson of Paulson & Co. This makes it all the more reasonable to implement a market neutral strategy until the political risk portion of market risk has further transparency. We do not know what the future regulations hold for this industry, and thus until President-Elect Obama, the Democratic Congress, and, most importantly, those advisors chosen by President-Elect Obama unveil their regulatory plan we will look to continue a bottom-up approach industry by industry.

