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CHILDREN'S LETTERS TO GOD, **or WHY DOESN'T THE MARKET ANSWER WHEN YOU CALL?**

Well, we certainly have seen some exciting events in the U.S. stock markets this winter, haven't we? Bear Stearns collapses overnight. Our equity markets all go in the tank. Treasury yields fall to a 50-year low. The Fed commits taxpayer money to guarantee potential big bank losses. Exotic instruments called credit default swaps and collateralized debt obligations confuse and confound even their creators. Oil goes over \$100 per barrel. Liquidity evaporates. We remain stuck in Iraq with no apparent satisfactory end game. And the North Carolina Tar Heels lose their mojo in the Final Four.

It's at times like these that I love to flip through the pages of a book called *Children's Letters to God*. Each page contains a question handwritten by a youngster to God.

Here's one:

"Dear God,

How come you did all those miracles in the old days and don't do any now?

-Seymour"

Yeah, how come, God? We could use a miracle or two now.

Here's another:

"Dear God,

Please send me a pony. I never asked for anything before. You can look it up.

-Bruce"

If not a pony, a gift of market stability would do. Less volatility would do. The trading of auction-rate preferred securities would do. A loosening of credit would do. Seeing the S&P, NASDAQ and Dow Jones in positive territory would do.

Business cycles have their own way of doing things. And our prayers regarding them rarely seem to be answered, indeed, if we even assume they are heard.

We just witnessed the worst stock market quarter in five years. When March 31st ended, the S&P 500 was down 9.9%. Its companion indexes did no better, with the NASDAQ Composite being off 14.1%, the Dow Jones industrial average off 7.6% and the Morgan Stanley EAFE Index, the bogey for international companies, off 9.5%. You have to go back to the third quarter in 2002, when the market lost 18% after WorldCom Inc. had the largest ever U.S. bankruptcy filing, to find another one so bad.

The first quarter's downturn, combined with the 3.7% loss in the last quarter of 2007, saw us with the first back-to-back losses since 2002. What's a party to do?

Well, prayers to God might help. (I know praying to the Tar Heel-in-the-Sky, as well as wearing Carolina Blue at the Alamo Dome, wasn't enough to bring the Tar Heels to victory in their semi-final loss to Kansas. I tried both.)

Actually, it's at volatile times like these when assets not correlated to the stock market are the most appreciated. I refer to bonds; I refer to cash equivalents or instruments which mature within 12 months; I refer to gold, commodities, and even the concept of short selling. At Westover we have feverishly been invoking all those strategies on a one-client-at-a-time basis in an effort to stem portfolio meltdowns. Fortunately, we've had success if you measure success against equity performance. Put another way, while losses for clients have been the norm this first quarter of 2008, none of them have been at the level of the S&P 500 losses.

But just as the gods taketh away so too they giveth. The first day the markets were open in April the S&P shot up 3.6%. That one day gain was the best start to any quarter since 1938.

So what's an investor to do? I suspect we could ask God to send us a pony or to perform a modern day miracle, but somehow I'm not quite sure he would honor either of those two requests. And if he doesn't, then the next best thing is to have a diversified portfolio. Hold stocks, bonds and cash.

Choose an appropriate risk level, titrated by the percentages of each of those three investment types, that permits you to sleep at night.

DO WE REALLY KNOW THE THINGS WE ARE SURE WE KNOW?

Last week a dear friend and former DuPont executive came to see me for purposes of having his annual Westover portfolio review. As is the case with some of our other clients, he has some of his investments with another investment advisor. Those investments are his non-equity investments and are designed to provide him with both liquidity and safety. Unfortunately, his other advisor placed his "safe, cash-like" assets in something called "auction-rate securities". They typically paid one percent more than corresponding money market yields, and required a minimum investment of \$25,000.

In reality they were long-term bonds treated as short-term securities. Investors could theoretically offer them for sale at auctions through their brokerage house.

The auctions were typically held every seven or twenty-eight days. At the auction the interest rates would get reset. Thus if you could afford to wait a short period of time, say a week or a month to get access to your money, you could receive an interest rate substantially higher than in a money fund. All was well and good this year until, in an instant, the demand for those securities evaporated. Something never expected occurred. The auctions failed. Liquidity disappeared. My client's investment became frozen.

The *Wall Street Journal* reported one poor investor who sank \$4.5 million into auction-rate securities through Deutsche Bank several months ago because he was nervous about the stock market. His investment is also frozen. He can't get access to it. To add insult to injury some brokers have now even announced they plan to cut the value of those auction-rate securities, perhaps upwards of 20%. And I thought the Tar Heels had problems!

Thanks to the excellent advice I received from a bond professional at Merrill Lynch by the name of Lisa Quadrini, Westover moved all our clients out of auction-rate securities late last summer. Many times I've thought, "There but for the grace of God go I." Phew! I'd have been writing my own letter to God asking for more than a pony if my client were asking me why his so-called secure Westover money market substitute was totally illiquid. And perhaps diminished in value.

IF IT WALKS LIKE A DUCK AND QUACKS LIKE A DUCK. . .

Are we in a recession? This is a question commonly asked and broadly debated. I don't claim to have a Ph.D in economics, but as one famous Supreme Court jurist, Potter Stewart, said about pornography, "I know it when I see it". The economists who support President Bush say we are not there yet, but most everyone else says we are. I am in the camp that says we are.

Former Fed Chairman Alan Greenspan says we are in a recession. Warren Buffett agrees. According to a recent *USA Today*/Gallup poll a majority of the U.S. man-in-the-street, three- out-of-four to be exact, believe we are in a recession.

So, if we are in a recession what does that mean? Well, it means mostly bad things. Jobs are eliminated. Credit gets tight. Markets go down. Vacations get postponed. Consumer confidence swoons. Fewer products are manufactured, sold and consumed. I'd say that's about where we are now, wouldn't you?

The next two important questions then are (1) how long will it last and (2) what can we do about it. Recessions typically last about ten months but they have been known to last many more than that. Bear markets in equities typically end four or so months before recessions end. Merrill Lynch is on record as predicting that this recession will likely end in December. If that is correct then the stock market should bottom out in late summer. The typical peak-to-valley decline in a stock market recession is about 30%. We are not that far along yet, but the trend is certainly not our friend.

An indicator of recessionary bottoms can be found when consumer confidence, as measured by Conference Board, is at the 60-65 mark. Presently it is at 75. Another important indicator of market bottoms is when the jobless rate has risen by 1.5% points from its cycle low. For our purposes that's about 6%. Some economists see that occurring by the end of 2008. The unsold inventory of new and existing homes is still at about approximately a ten-month supply. It needs to get to seven months or so, those pointy-headed economists tell us. And finally, look at the interest rate spreads between the two- year treasury and fed funds rates. Presently it is a negative 55 basis points (It is inverted). Typically twenty basis points on the positive side suggests that better times are ahead.

So, what's a man overboard to do while he waits for a boat to rescue him? Here are a couple of ideas which Westover has

been actively employing. (1) Look for strong dividend-paying companies. Examine particularly solid but beaten-down names. The pharmaceutical industry is one to look at in this regard. (2) Consider taking a chance on battered stocks. Consumer staples as well as healthcare are both defensive and potential good plays. At present I still think the financial sector is a value trap. (3) Diversify globally. (4) Look at large-cap sectors, and slightly emphasize those on the growth side of the equation.

Business profit cycles are a significant determinate of relative performance of asset classes, styles, sectors and industries. When earnings growth rates increase, lower quality and more value-orientated investments typically out perform. In that environment, which we saw two years ago, it made no sense to pay a high valuation for growth when many more conservatively-valued companies could offer similar earnings and growth prospects.

Today, however, when profit cycles have decelerated and earnings growth rates have slowed, growth becomes increasingly scarce. At times such as these, investment performance is determined by survival of the fittest. In today's environment we should emphasize high quality bonds, large-cap U.S. stocks, defensive sectors, developed markets and a high-quality dividend strategy.

Those are the themes we are following today. Maybe we can help you. If you still don't have a pony, give us a call.

LISTEN TO THE MUSIC

The last three quarters we've asked questions dealing with jazz, classical music and musicals. The winner of our most recent quiz successfully identified the play *Mama Mia*. That was also the title for a song sung by the Swedish Group, ABBA. Congratulations to Christie and Matt Di Guglielmo, a lawyer and doctor respectively with two darling daughters.

This quarter's quiz will return to our rock-n-roll roots. Cover songs are those sung by a second group after the song was originally made famous by a first. I'll list five songs and give you nine groups or individuals. Your assignment is to identify the first group or artist to have sung the song and the second who covered it. (Hint: one party played both roles.)

SONGS:

- "Dedicated To the One I Love"

- "Ooh Baby Baby"
- "Breaking Up Is Hard To Do"
- "Handy Man"
- "Hound Dog"

ORIGINAL or COVER ARTISTS (no particular order):

- Linda Ronstadt
- Big Mama Thorton
- Neil Sedaka
- Dell Shannon
- The Mamas and Papas
- The Shirelles
- Smokey Robinson and the Miracles
- Elvis Presley
- James Taylor

As always, good luck and please be sure to follow Westover's no-Internet-search honor code. The winner will receive a \$100 gift certificate to the restaurant of his or her choice.

And remember, no how matter how poorly you think the market has treated you, at least you're not Joseph Lewis. That man truly needs a modern day miracle.

The British-born currency trader and multibillionaire made a huge bet seven months ago that Bear Stearns, which at that time had already lost 30% of its market value, was a bargain. The septuagenarian built a stake approaching 10% in the investment bank, paying about \$100 a share for the majority of his eleven million shares according to U.S. regulatory filings. In doing so, he became Bear Stearns' largest individual stockholder. When the dust settled last month Lewis had lost 90% of the value of his investment in a little more than half a year. It's value? Approximately \$850 million. Ouch! Better put that new yacht on hold, Joe.

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