



First Quarter 2009 Commentary and Outlook

Despite a powerful rally that carried the equity market up 17.9% from March lows, the S&P 500 ended the first quarter of 2009 down 11.0%. The advance, the best one-month performance period for equities since 1973, came on the back of the Federal Reserve's move to quantitative easing. Cyclical stocks trended stronger and credit markets signaled reduced deflation concerns. Commodity prices, led by oil and industrial metals, shifted to recovery mode. The message behind this price action is clear: markets have begun discounting economic recovery. Given the magnitude of the financial stimulus being put in place, this seems a reasonable assumption, except for the inconvenient fact that the financial system remains broken.

A Healthy Financial System: Essential for Sustained Economic Growth

By the fourth quarter of 2009 and through 2010, the trend in economic activity and corporate profits is likely to be positive, albeit at diminished levels from recent peaks. However, a functioning financial system is required in order for these favorable trends to develop and be sustained. At the moment, this condition is far from being met, which presents a serious impediment to sustained recovery.

Following the bankruptcy of Lehman Brothers, which brought the near meltdown of our financial system, the government helped stabilize the banking system with several programs, including expanded deposit insurance limits and FDIC guarantees on bank debt. Moving forward, the government is putting its faith in an alphabet soup of programs, including the Public Private Investment Program (PPIP) and the Term Asset-Backed Securities Loan Facility (TALF), initiatives designed to help recapitalize commercial banks and the "shadow banking system" (SBS). The success of these programs is essential to rapidly restore the health of our financial system and in turn to avoid a negative feedback loop of rising corporate bankruptcies and substantially higher unemployment that would weigh heavily on our economy, placing further strain on the already weakened financial sector.

PPIP: Seeking Recapitalization of Commercial Banking

The government's PPIP is designed to remove toxic assets from the books of commercial banks and, along with stress tests, to determine the amount of capital required to recapitalize the banking system and normalize lending. The ultimate success of this important program will likely be determined by several issues and challenges, including:

- Whether buyers (PPIP participants) and sellers (commercial banks) prove willing to clear adequate amounts of so-called legacy assets from bank balance sheets
- If the amount of capital required to effectively recapitalize our commercial banking system is readily attainable

The amount of capital required remains unclear. If it turns out that something comfortably less than \$500 billion in additional capital is needed to recapitalize the banking system, an amount well within the \$200 billion to \$1 trillion range that some seasoned observers have held out as an estimate, then there is a reasonable probability of the task being accomplished. A recapitalization of this size would be a constructive development, although it would also likely be a step forward in de facto nationalization, as it would require government-held preferred shares be converted into common equity, placing the government in the position of controlling shareholder in some instances.

If, however, as we suspect, the cost of recapitalization is closer to the high end of the range of estimates, then the challenge is more daunting. In the nearer term, the conversion of the government's preferred shares into common equity and retained earnings of the banks would likely provide only around one-third of the required capital in this scenario. The remaining gap would require capital from the private and/or public sectors. In the face of ongoing credit erosion and with the prospect of further government involvement, private investors are unlikely to step forward to fund aggressively. This leaves the public sector, where questions already surround the political will of Congress to step forward in the face of a populist backlash against "bailing out Wall Street fat cats," as the lone meaningful source of capital. In addition to political considerations, financial-market constraints would likely come into play as foreign and domestic buyers of U.S. government debt would weigh the benefits of continuing to buy Treasuries against concerns about the prospect of several years of multi-trillion dollar budget deficits.

On balance, if effective recapitalization can be accomplished for something less than \$500 billion, then we believe there is reasonable likelihood of success. If, however, recapitalization requires capital infusions approaching \$1 trillion, then the challenge is much greater, the solution unclear and the resulting uncertainty would likely prove unsettling to financial markets.

The Shadow Banking System: Ignored but Essential to Full Recovery

Even if the commercial banking system regains footing, a revitalized shadow banking system would likely also be required to recapture the vitality of our financial system and the broader economy. The SBS, a complex interplay of banks, hedge funds, structured investment vehicles and other entities, evolved over the past 20 years to become the preeminent source of consumer credit. The SBS creates securitized assets from mortgages, to student loans, to auto financing and credit card lending. At its recent peak in 2005-2006, this alternative system created \$2 trillion of credit via securitization, far more than the \$800 billion of credit generated by the commercial banking system. In the past year, the SBS ceased functioning as lenders shunned risk. For the first nine months of 2008 only about \$140 billion of credit was created via securitization, and in the fourth quarter, following Lehman's collapse, securitization contracted by nearly \$80 billion. It has not yet demonstrated signs of meaningful recovery.

TALF, the Federal Reserve's first effort to fill this void, has generated limited investor interest to date. If the program fails to gain traction, it may serve to highlight the enormity of challenges involved in restoring our financial system to health.

Investment Strategy to Capitalize on Economic and Financial Environment

The challenges and uncertainties surrounding resolution of this credit crisis serve to reinforce our investment strategy. We believe we are in a period characterized by sub-optimum economic growth and severe constraints on available capital from financial intermediaries. In this setting,

we are focused on investing in companies with strong financial postures and managements skilled at capital allocation, because these businesses will be in a preferred position to gain market share and acquire strategic assets at attractive prices from strained competitors. These opportunities may translate into significantly enhanced earning power and superior free cash generation. We have identified businesses which we believe meet our demanding criteria and will opportunistically build your investment positions in them. This strategy, successfully implemented, should produce handsome long-term returns for patient investors.

Sincerely,



Michael A. Steinberg
Managing Partner