



Second Quarter 2008 Commentary and Outlook

A relief rally triggered by the Federal Reserve's rescue of Bear Stearns in March carried equity markets upward through mid-May when the core dynamic of the current credit squeeze resurfaced: the interaction between a structurally weak financial sector and a slowing economy. These concerns were intensified by the resurgence of inflation risk brought on by record oil and food prices. Equity markets experienced one of the worst Junes on record. The Standard & Poor's 500 Index finished the quarter with a loss of 2.73% and registered an 11.91% decline for the first six months of the year.

Companies in the financials sector contributed the bulk of S&P 500 losses in the quarter, joined in weakness by the industrials and consumer sectors. The energy, technology, utilities and materials sectors made positive contributions to index returns. The disproportionate weakness among large financial stocks contributed to U.S. value indices trailing their growth counterparts and large-cap stocks underperforming small- and mid-caps for the quarter.

Stagflation Threatens a Return

The surge in energy prices has added a new and unwelcome threat to the economy: stagflation, the rare combination of economic weakness along with sustained higher inflation. Recent sharp increases in the price of oil have added velocity to economic headwinds by squeezing consumers' already taut cash flow and introducing new inflationary pressures as businesses raise prices to recover energy-related cost increases.

An important consequence of the stagflation threat is the policy challenge it presents. Monetary policy is not equipped to coincidentally control inflation and stimulate economic growth. Taming inflationary pressures at a time of cyclical economic weakness and financial system vulnerability requires a difficult balancing.

- If the Fed underestimates the inflation threat, the rate of price increases could accelerate, likely inducing higher long-term interest rates and dampening economic growth in the long-term. This would likely aggravate strains in credit markets and generally reduce the value of assets as a steeper discount rate is applied in valuing future cash flows. This could be particularly troublesome for the already fragile balance sheets of some financial institutions.
- If the Fed overestimates the threat and raises rates excessively to preclude inflation from taking root, this would likely depress economic activity and aggravate credit markets, at least in the short-term.

These two unappealing policy alternatives provide little basis for optimism. A more attractive outlook comes in the form of relief from oil-fueled inflation, which would likely take the need to pursue the threat of inflation off the table.

Crude Oil: Supply, Demand and Risk

A major drop in oil prices, due either to supply increases or demand reduction, would present constructively for the economy and capital markets and would potentially spare monetary authorities the policy conundrum that accompanies stagflation.

Elements of demand destruction – substitution, conservation, slowing growth – are widely evident. They would normally suggest a meaningful decline in the price of oil were it not for the uncertainties underlying supply. Planned production increases in Saudi Arabia and Iraq bode well for the hopeful scenario. Unfortunately, they may be offset by ongoing and seemingly inevitable interruptions to supply, such as have occurred recently in Nigeria and elsewhere. Moreover, the risk premium priced into oil markets covers steep geopolitical threats. These include political instability throughout the oil-producing world, most notably Iran's destabilizing nuclear program. The high risk premium in oil prices is unlikely to be eliminated until the Iranian issue is resolved, a development that may not occur in the immediate future.

Uncovering Opportunities: Free Cash Flow Generation Remains Key

Developments in credit markets and the economy portend an extended period of sub-optimum growth and a reduction in the level of available capital. Our investment strategy positions us to capitalize on opportunities this challenging environment presents.

To capitalize on the prevailing tight-credit and slow-growth conditions we will primarily select securities of businesses whose base cash flows are not built on high levels of operating or financial leverage. We seek companies where managements have demonstrated the ability to effectively employ a strong financial posture to materially enhance free cash generation. This strategy holds exceptional potential because the current challenging environment is likely to allow well-positioned businesses the opportunity to purchase assets with high strategic value at attractive prices due to the financial challenges facing some companies. We have discussed several of these types of investments in prior letters.

Recently, we have identified several companies in the process of developing new products to serve markets which are exceptionally large relative to their market capitalizations. The strong financial postures and solid asset backing of these businesses create outstanding long-term risk-reward profiles. We plan to capitalize on opportunities created by the market's downside volatility to build your investment position in these as well as other securities we believe have outstanding risk-reward profiles and potential to provide superior long-term returns for your portfolio.

Sincerely,



Michael A. Steinberg
Managing Partner