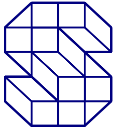

Steinberg Asset Management, LLC

Fourth Quarter 2008 Commentary and Outlook

Equity markets remained highly volatile in the quarter as deleveraging intensified and economic indicators continued downward. These negatives were offset by lower energy prices, continued government interventions in support of credit markets and news that the Obama administration will seek quick implementation of a substantial stimulus package. The S&P 500 Index ended the quarter on mixed results – 22% lower for the period but more than 20% higher than the low it hit November 20th.

Deleveraging: Widespread but not Uniform

Global deleveraging continues in 2009 and may extend beyond. Although the term deleveraging is in common use to describe the current actions of a variety of creditor classes, the effects of deleveraging are as varied as the parties undertaking it. They will likely create a range of potentially significant repercussions for investors. In particular, the deleveraging of hedge funds, consumers and financial institutions offer starkly different characteristics and implications.

Hedge Fund Deleveraging: Contraction Creates Opportunity

Investor redemptions along with market losses, and dramatic reductions of bank credit pressured hedge funds into widespread forced sales of equities in the quarter. With equity markets lacking sufficient liquidity to absorb the increased supply of for-sale securities, steep share price declines resulted. For many businesses, this opened large discounts between the fundamental value of their equities and their share prices. As destabilizing as the impact of hedge fund deleveraging has been, it is important to note that the forced selling has not detracted from the fundamental value of those businesses whose shares were caught in the liquidity squeeze.

The supply/demand balance for equities should improve in 2009 because the bulk of forced selling appears to be behind us. Massive redemptions have significantly reduced the size of the hedge-fund industry. At the same time, demand for equity securities may increase in coming weeks if institutions rebalance their portfolios to match their asset allocation targets for stocks and bonds following the outperformance of fixed income assets relative to equities in 2008.

For all of these reasons, investing in businesses that have been marked down due to deleveraging, but which have not been impaired financially and have attractive future growth prospects should yield highly attractive long-term returns.

Consumer Deleveraging: Spending Reductions Challenge Recovery

2000 through 2007 represented a unique period in history in which increasing values of homes and retirement accounts made it less imperative for consumers to reduce spending in order to save for retirement. As a result, the consumer savings rate declined steadily reaching the 0% mark in 2005. This was a significant departure from the more normalized 8% to 10% savings rates of the mid-1990s. Recent erosion in the value of home equity and investments has reversed this behavior. Consumers have begun curtailing spending to bolster savings. In November, consumer spending dropped and the savings rate increased from 0% to an estimated 2%.

Given the recent reduction in consumer net worth, savings rates could reasonably be expected to increase to at least the 10% mark, especially considering the greater proportion of the population approaching retirement today than during the 1990s. While this behavioral shift may be prudent for individuals, it carries potentially adverse consequences for the economy and capital markets. An increase in the savings rate to 10% of disposable personal income from 2% would reduce spending by roughly $900 billion in our $14 trillion economy. If a spending reduction of that magnitude were to occur over two years, GDP would be reduced by roughly 3% per year in each of the next two years; a speedier reduction in spending would reduce GDP even further in the near term. While the magnitude and timing of an increase in savings are unknown, they will meaningfully shape the path of economic activity.

Government stimulus spending could meaningfully offset consumer deleveraging although it is unlikely to have significant impact much before the end of 2009. President-elect Obama's plan for rapid deployment of close to $1 trillion in federal spending over two years, coupled with government efforts to lower mortgage rates by purchasing mortgage securities, may soften the impact of reduced consumer spending on GDP. Nonetheless, with corporate capital spending and exports unlikely to show growth in the current economic environment, even substantial government spending is unlikely to prevent flat to very low GDP growth over the next two years.

Financial Institution Deleveraging: Unanswered Questions

To date, financial institutions have written off some $1 trillion globally and about $700 billion domestically, most of which has been replaced by fresh capital. It remains to be seen how much more will be written down and, more critically, what portion of future write-downs/write-offs will be met with fresh capital replacement. As we have noted previously, every $100 billion reduction in after-tax equity reduces available credit by approximately $1 trillion due to the multiplier effect. This is of enormous significance in a financial system where consumer, industrial and real estate loans at commercial banks total $7 trillion.

Until credit markets stabilize, financial institutions will be unable to accurately determine the value of their assets. This serves to further reduce their willingness to lend and compromises their ability to recapitalize strained balance sheets.

Although consumers and corporations are generally not seeking growth capital, they urgently need to refinance existing loans at reasonable rates. Without the ability to refinance mortgages and corporate debt, the economic downturn may worsen; therefore, it is essential that credit not contract. Given these circumstances, it is encouraging to see that government efforts to heal the credit markets may have begun to accomplish the task, as evidenced by declines in LIBOR, mortgage rates and credit spreads.

2009 May Provide Some Relief for Equity Markets

Equity markets may be pressured in early 2009. Investors will digest poor earnings news in the form of fourth quarter reports and 2009 forecasts. In addition hedge fund liquidations may continue as a consequence of the roughly $300 billion in assets that were estimated to be gated during the later part of 2008. Moving through 2009, however, the combination of a better supply/demand balance for equities coupled with a substantial government spending program, aggressive government efforts to put a floor under housing prices, and a more comprehensive approach to managing the credit crisis than we have experienced to date should help boost investor confidence, a critical step towards creating a better tone for our financial markets.

Investment Strategy to Capitalize on Challenging Environment

In prior letters we shared our view that the investment landscape will continue to be characterized by sub-optimum economic growth and scarce capital. The thrust of our strategy is to capitalize on this environment by investing largely in businesses with low levels of operating and financial leverage and skilled managements with demonstrable success in capital allocation.

We believe the successful implementation of this strategy will yield compelling long-term returns because well-financed businesses with relatively stable free cash flows are in position to increase market share without engaging in predatory pricing. They are poised to do so at a time when many competitors are struggling to finance ongoing activities. In addition, these businesses should be in a position to acquire strategic assets at reasonable prices. These factors should materially enhance longer-term earning power and cash generation for well-positioned businesses.

These types of investments hold the potential to preserve and enhance the real value of capital in a world in which capital faces serious challenges from deflation in the near-term to the potential for inflation in the longer-term.

Sincerely,

Michael A. Steinberg
Managing Partner