THE DEVIL'S ADVOCATE REPORT COMPENDIUM

November 2008

Featured Companies:

Gabelli Utility Fund (GUT)
DNP Select Income Fund (DNP)
General Motors (GM)
Ford (F)

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Exclusive Marketers of
The Devil's Advocate Report

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Murray's Musings

The *Musings* today are about my views of the capital markets action during the last ten months, and why they are at such great variance with the consensus. Perhaps there's a structural flaw in the manner in which I approach the data, or perhaps there's a structural flaw in the way other people approach the data. Whichever it is, my opinions could not be more at variance with the majority.

Much of what's happened in the markets, and much of what's happened in the economy, pertains to credit default swaps. I believe that those securities are at the heart of everything. In order to understand why that's my view, wrong headed as it may be, let's return to the beginning of the year.

In the beginning of the year, various mortgage backed securities had to be marked to market. Many mortgage backed securities had credit default swaps associated with them. Many well known firms wrote credit default swaps. Most of those securities have a provision in the agreement called the Credit Support Annex, or the CSA, which provides something crudely analogous to what the clearinghouse function is in an exchange. If the underlying instrument upon which the insurance is purchased drops beneath a certain predetermined level, the seller of the insurance (if we look at credit default swaps as a type of insurance) is obligated to post collateral.

In a crude mathematical sense, that procedure is not radically different from that used for a commodity future. For example, if I were to be long or short soybeans on the Chicago Mercantile Exchange, and the trade moved against me, since the trade was originally executed at a 50-fold leverage ratio, I would need to post collateral, literally every day. In the language of the Chicago Mercantile Exchange, that collateral post is referred to as margin variation. Let's assume that on a given day I needed to post margin variation. Essentially, I would wire money into the clearinghouse. If I were short soybeans, someone on the other side of the trade would be long soybeans. The clearinghouse is the counterparty for both sides of the trade.

On the Chicago Mercantile Exchange, in the above situation, if the trade moved against my short position, the person who was long soybeans would get positive margin variation, which means that some of the collateral of the original trade would be returned to the clearinghouse. It is not returned to the person who was long soybeans, because the real counterparty for both sides of the trade is the clearinghouse. In that type of trade, there is an offsetting movement of margin. That offset is not what happens in a credit default swap.

The procedure for credit default swaps differs because, if I had written credit enhancement on a given security and that security dropped to a predetermined level, I would need to post collateral. My counterparty, however, wouldn't have access to the collateral. Therefore, once the market went down, it would affect the credit default swap community and cause the market to become somewhat self-reinforcing. In other words,

any trend manifested in the credit default swap community becomes self-reinforcing. The writers of the insurance are required to post collateral, which they didn't anticipate having to post. They sell securities to raise the money for the collateral. The people on the other side of the transaction don't get the collateral; they can't necessarily have access to it. If you're required to post collateral and you sell securities, that action drives the securities to a lower price level, which in turn obligates you to post more collateral, and so on and so forth down to some predetermined level. Most Credit Support Annexes provide a maximal base amount of collateral.

Once you reach the maximal base amount of collateral, the entire situation becomes binary. Either the underlying will not trigger a payment in the credit default swap (i.e. the underlying will not default), in which case the collateral will ultimately (and ultimately can be a very long time) be returned to the insurer, so to speak. Alternatively, if there were a credit event in which a payment needed to be made, the collateral would be released to the purchaser of the insurance.

What I believe happened in the last ten months is that all sorts of insurers, largely major banks and investment banking institutions, were required to make collateral payments that ordinarily they would be able to satisfy by going into their credit lines, but they all drew on their lines at about the same time. There was a mad rush that effectively froze the credit markets and made credit unavailable. I believe that's what happened to companies like American International Group.

It's not that American International Group was insolvent in the sense that its assets had no value; it's that it was *technically* insolvent in the sense that it couldn't meet its obligations to post collateral, because it couldn't access its credit line. The company had assets, and ordinarily it would be a marvelous counterparty to have, but the assets weren't readily liquefiable.

Of course, that situation had ramifications for the broader economy, because once the credit markets froze, they froze for all participants, not merely for the credit default swap participants. As a result, available credit instantaneously froze for a broad range of entities from municipal bond participants to small businesses requiring access to a line of credit, which had obvious consequences for the whole economy.

The credit markets will unfreeze after a certain base amount of collateral post is reached, although that might take a very long time. Therefore, I regard the last two weeks as the moment in time when most of the companies reached their limit in collateral post. In any event, they are getting assistance from the Federal government to meet their collateral obligations. From this point forward, that circumstance should begin to correct itself via the market mechanism.

It's impossible to know to what degree it will correct itself, nor the speed at which it will happen. I believe that it is in the process of correcting itself. The valuations of many companies that we've commented upon in past reports don't necessarily reflect a deterioration of economic fundamentals, but they do reflect the entire freezing of the

credit markets. The valuations on many companies make no sense, even if there were a repetition of the Great Depression, which I personally don't expect there to be.

The media wouldn't see it this way. The credit default swap market is arcane, the information available is minimal and one is at a loss to view that entire market as an organic whole. It's a global market with a plethora of participants, and the nature of the exposure is impossible to determine. Ergo, the media focuses upon the deterioration of the economy as an explanation for the deterioration of securities prices and, of course, the deterioration of security prices is nothing other than a reflection of the economy. As a causal explanation, it leads us nowhere.

If security prices reflect the deterioration of the economy, then we have to understand why the economy deteriorated. The sub-prime mortgage problem might be a reasonable cause, except that the sub-prime mortgage problem really began in 2007. Why did we have a sub-prime mortgage problem? Certainly, it was a major factor in the first two quarters of 2008, when the economy, while not robust, was at least growing. Even for the third quarter of 2008, the preliminary estimate is a 0.3% decline in the economy, which is not exactly a disaster.

At least until September 30th, we have no evidence of a debacle like the Great Depression. Perhaps we will have an experience like the Great Depression, but there is no evidence of it; there is merely evidence of a slowdown. Since the slowdown is occurring after the freezing of the credit markets, not before, we have to understand why the credit markets froze. We can't say that the credit markets froze because the economy deteriorated, because the deterioration occurred after the credit markets froze.

It's a real problem, because most people's information comes via popular media organs like newspapers and television, which are impressionistic. The media articles are derived and written in a hurry; there is very little time for reflection and analysis. The analysis that does occur is usually done in a combative manner. There are usually two antagonistic parties that completely disagree upon the facts and on what needs to be done in relation to the facts. The participants are usually very impolite to one another and, rather than acting as a forum for reporting facts, it becomes another form of entertainment.

A combative approach is nothing new in media as evidenced by looking back two centuries to when James Franklin, the brother of Benjamin Franklin, was the publisher of the New England Courant. In his newspaper, James Franklin attacked Cotton Mather and a doctor named Wilson because they wanted to introduce smallpox inoculations to the city of Boston to prevent an epidemic. If you read the critical articles, they accuse those two gentlemen of being part of a scheme to depopulate the city by inoculating people with the small pox virus and, thereby, lowering real estate prices. It's astonishing.

For amusement purposes and to further illustrate how far off the media can be, I'll read into the record excerpts from a book called *Pushcart's Complete Rotten Reviews and*

Rejections.[1] This book includes reviews published in the then great media organs of what we now believe to be great works of literature. These particular reviews were written by other creators of great works of literature. For example, Mark Twain wrote a review of James Fenimore Cooper's *The Deer Slayer*. The review was written in 1897, 56 years after James Fenimore Cooper published the work. You might feel that Twain was a bit extreme.

> In one place in *Deer Slayer* and in the restricted space of two-thirds of a page Cooper has scored 114 offenses against literary art out of a possible 115. It breaks the record.

Here is an 1842 review written by Edgar Allen Poe about his contemporary essayist, Ralph Waldo Emerson.

> [He] belongs to a class of gentlemen with whom we have no patience whatever – the mystics for mysticism's sake … The best answer to his twaddle is *cui bono?* – a very little Latin phrase very generally mistranslated and misunderstood – *cui bono?* To whom is it a benefit? If not to Mr. Emerson individually, then surely to no man.

To show you that this went on throughout history, here is the opinion of Aristophanes, the Greek playwright, on his contemporary, Euripides:

> A cliché anthologist … and maker of ragamuffin manikins.

The notable French newspaper *Le Figaro* in 1857 had the following comment about Gustave Flaubert's work Madam Bovary:

> Monsieur Flaubert is not a writer.

In 1961, when the Joseph Heller novel *Catch 22* was published, here's what Whitney Balliett of *The New Yorker* thought of it:

> Heller wallows in his own laughter and finally drowns in it. What remains is a debris of sour jokes, stage anger, dirty words, synthetic looniness, and the sort of antic behavior the children fall into when they know they are losing our attention.

And William Barrett of *Atlantic Monthly*:

> There is a difference, after all, between milking a joke (the great gift of the old comedians) and stretching it out till you kill it. Mr. Heller has enough verve not to have to try so hard to be funny.

Finally, *The New York Times* book review:

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[1] *Pushcart's Complete Rotten Reviews and Rejections*. Bill Henderson and André Bernard. New York: Pushcart Press, 1998.

> It gasps for want of craft and sensibility. The book is an emotional hodgepodge. No mood is sustained long enough to register for more than a chapter.

The *San Francisco Examiner,* rejecting a story submitted by none other than Rudyard Kipling, wrote:

> I'm sorry, Mr. Kipling, but you just don't know how to use the English language.

Here is what Samuel Taylor Coleridge, one of the greatest English poets, said in 1796 about John Milton's *Paradise Lost* written in 1667.

> … do you not know that there is not perhaps *one page* in Milton's *Paradise Lost* in which he has not borrowed his imagery from the *scriptures?* I allow and rejoice that Christ appealed only to the understanding and affections, but I affirm that after reading Isaiah, or St. Paul's *Epistle to The Hebrews*, Homer and Virgil are disgustingly *tame* to me and Milton himself barely tolerable.

To show you that this went on, here is George Bernard Shaw in *The Saturday Review* in 1898 reviewing the Shakespeare play *Julius Caesar*:

> There is not a single sentence uttered by Shakespeare's Julius Caesar that is I will not say worthy of him, but worthy of the average Tammany boss.

And to show you this happened in all ages, the famous diarist in the 17th century, Samuel Pepys, said the following about *Romeo and Juliet*:

> March 1st – To the Opera and there saw Romeo and Juliet, the first time it was ever acted; but it is a play of itself the worst that ever I heard in my life, and the worst acted that ever I saw these people do …

The last example shows that George Bernard Shaw himself was the recipient of criticism by none other than Bertrand Russell:

> I think Shaw, on the whole, is more bounder than genius … I couldn't get on with *Man and Superman*: it disgusted me.

And there you have it. This is the record, at least in one modest sphere of the media. It's a record that, when written, elicits great comment that is completely forgotten some months after, not because there aren't brilliant, skillful, dedicated people in the media; there are. It's simply because there is no time, or opportunity, to engage in analysis; there's no time allowed for reflection, or thought. The news that is emitted is necessarily impressionistic and, I would argue, necessarily wrong. It doesn't mean that what I say is right, but at least we have the opportunity to gather data, to reflect and ponder issues. If necessary, we can amend a view that we believe to be wrong.

I don't believe we're entering another version of the Great Depression. I don't believe that single-digit multiples on so many large capitalization quality companies with

relatively unlevered balance sheets represents the market saying we're about to enter the Great Depression. I think it's something else. Time will tell whether I'm right or wrong, and we'll know in not very many months.

If we *are* entering the Great Depression I'll have to retract my comments. However, if we are *not* entering the Great Depression I don't think you'll find anyone in the media retracting anything. I think it will simply be forgotten and they'll move on to an entirely different subject.

Industry Remarks

If one agrees with the sentiments expressed in the *Musings*, it would appear to me that the logical way, in an investment sense, of expressing those sentiments would be to buy asset management companies. Taken as a group, the asset managers have declined as much as any group, including those companies exposed to real estate. There are asset managers themselves that are exposed to real estate, others to commodities, and still others that are neither exposed to commodities nor real estate; yet, they have all declined together, because it is presumed that the investment climate is going to be so fearsome, so hideous, so unmanageable that every investment manager will simply lose assets. I think that's completely illogical.

Ultimately, something will prove to be a good investment. Maybe it's not clear at this point what it's going to be, but if one knew it, one would do better, as a basic proposition, by investing in an asset manager than by investing in that business. The reason is that, if the underlying is a good business, it should logically appreciate in value. The advantage of an asset manager is that it gets the operating leverage in the form of increased management fees that the underlying investment doesn't necessarily achieve. Also, as a second order level of operating leverage, the asset manager would attract new assets.

If one believes that we're not entering the Great Depression, asset management companies are probably a logical place to be. One is encouraged to study the Asset Manager Indices provided at the end of this report for a list of companies[2].

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[2] See Appendix A and Appendix B on pages 18 - 19.

Featured Companies

Gabelli Utility Fund (GUT)

Believe it or not, as of Friday, October 31, the Gabelli Utility Fund traded at a 48.4% premium to net asset value. Its five-year NAV rate of return of 11.51% is inferior to the five-year S&P Utilities Index return of 12.54%; however, since the Gabelli Fund's inception, its return is higher than the S&P Utilities Index rate of return. The Gabelli Fund's inception rate of return is 10.7% and, over the same period, the S&P 500 Utilities Index has a return of 4.08%. The inception date of the Gabelli Utilities Fund is July 9, 1999[3].

Approximately 45% of the Gabelli Utility Fund is invested in standard electric utilities including Allegheny Energy, Florida Power and Light, Constellation Energy, Integrys, Unisource, Wisconsin Energy, and Progress Energy. It's a well diversified fund. The fund itself is 25% leveraged through the medium of adjustable rate preferreds. In a normal environment, adjustable rate preferreds might have a cost of capital of about 2%. If the average utility yields much more than that, which it does, one would generate, through that mechanism, a higher rate of return. It turns out that the Gabelli Utility Fund is actually redeeming 10% of the adjustable rate preferreds on November 11th, 2008.

Since even at this date, and even taking into account the penalty rate on adjustable rate preferreds, the yields in utilities are higher than the adjustable rate preferred yield, this is a guaranteed reduction of return from the point of view of the fund, unless one believed that utilities were going to decline further; in which case it would be a mitigation of risk.

With this security, one could either sell it short or hedge it with a standard utility fund, or a standard exchange traded fund that has a similar character. If one undertakes to borrow the Gabelli Utility Fund in order to sell it short, it should be understood that one is not likely to be able to borrow the shares at a large institutional broker, because the large institutional broker is not likely to have this security in custody, since it is a retail stock. One would need to borrow this security from a broker that has a large retail business. Only that type of broker would be likely to have access to it.

DNP Select Income Fund (DNP)

DNP Select Income Fund started its life as a utilities fund. It has altered its investment character to the extent that 65% of its assets must be invested in utilities, which it does. In February 2007, the board decided that six and a half cents per month per share will be distributed as a dividend, even if it needs to be made from principal, which it sometimes does. This fund trades at a 24.1% premium to NAV. Apart from the dividend, there's no

[3] Source: The Gabelli Utility Trust Shareholder Commentary, September 30, 2008

logical reason for having a fund of this type trade at a premium. The 10-year annualized rate of return, such as it is, is 6.7%. The largest holdings include FirstEnergy, Exelon, FPL Group, Southern Company, NStar, Verizon, XCEL, AT&T, Duke Energy and Dominion Resources.

The leverage ratio in this fund is 35%, and it's leveraged with two types of preferreds: the adjustable rate preferreds (permanent capital) and the remarketed preferreds. They each have $500 million of capital. One could argue whether or not adjustable rate preferreds or even market preferreds are a sustainable and permanent part of the capital structure. I would say they probably are since, when preferreds are issued, they're issued as perpetual securities.

It's also worthy of note that this fund owns 5% in REITs. The fund's charter is to generate a reasonably high degree of income, which it can do, given the prices of securities today. The problem with it, however, is that it trades at a 24.1% premium, which is likely to disappear over time. I don't recommend shorting this security so much as I recommend selling it short and hedging oneself with long positions in ETFs that collectively mirror the structure of this portfolio -- meaning that one must find an exchange traded fund that invests primarily in utilities, and an exchange traded fund that invests primarily in REITs, or find an agglomeration of REITs that mirror the REIT exposure, and find a corporate bond fund that has the same type of corporate bond exposure as this fund has, which is not hard to do. Therefore, one could lock in a rate of return.

One could still argue that it will trade at a premium, because of the preferred structure. I don't think that's the case for two reasons. The first reason is that tax exempt funds in the closed end structure have the same kind of leverage, and they virtually all trade at discounts. This security is unique in that sense. The typical leveraged funds which, as a generalization, are limited to the tax exempt bond space, trade at discounts.

The second reason is that one could argue that this might have a higher rate of return on a prospective basis, because of the leverage. On one's long position, one could mimic the leverage and, therefore, cancel out the leverage advantage of the fund as a short position.

General Motors (GM)

Three years ago we recommended the short sale of General Motors[4]; this segment is just an update. The argument at that time was that General Motors was rapidly approaching a moment of truth in terms of its capital structure, which it has since reached. Shortly before that moment, however, Kirk Kerkorian took a very large position in the shares, which he eventually exited. After that series of events, General Motors experienced a gradual deterioration of its stock price and its balance sheet. At the moment, General Motors has, believe it or not, $56 billion of negative shareholders' equity.

[4] *Devil's Advocate Report* May 10, 2005

The largest of its many problems, in my opinion, is $47 billion of post-retirement health benefits, which is a balance sheet item as of June 30th, 2008. It is hard to imagine how that balance sheet item will not increase. The real problem in General Motors is not merely to restore the profitability of the enterprise, which is dependent upon the economy, competition, and many other factors. The problem in General Motors is to earn enough money so that, at minimum, it can offset the growth of post-retirement benefits and liabilities, the most important of which is healthcare.

In principle, General Motors could negotiate an end to the liability, but it can't negotiate an end to any liability without the concurrence and cooperation of the counterparty, in this case, the retirees. We must ask ourselves, what possible incentive could retirees have to surrender part of their post-retirement health benefits? One could make an argument in relation to the workers currently employed. They might decide that it would be better to secure some degree of permanence in their employment status in exchange for the future benefit of post-retirement healthcare. A retiree, however, has no employment status to protect. It only has a post-retirement healthcare benefit, as well as a pension benefit. That's why the problem is so intractable.

The company has $20 billion of cash on the balance sheet, but it's questionable how long that will last. General Motors doesn't have an enormous number of maturities coming due in the 2009 to 2011 period. In the period of 2009 to 2010, it has about $6 billion in debt maturing. In 2010-2011, General Motors has $5.8 billion of debt maturing. Even making liberal allowance for certain losses, the company appears to have enough cash to deal with its capital structure, such as it is. It might even be able to refinance that debt should it become necessary.

It appears the United States Department of the Treasury, at least for the moment, has declined to inject capital into General Motors. If it did (and maybe in a new administration it would), it's hard to imagine it would undertake a transaction that did not contain fairly onerous terms, because it would have to get stock in the company and, given the price of the stock, it would have to be fairly dilutive.

In this particular instance, should the government choose that method of funding General Motors, it would run a much greater risk of losing its investment than if it injects equity capital into JPMorgan, Goldman Sachs or some other such entity.

Another problem that General Motors has is that Delphi, which it spun off to the public several years ago, is still its largest supplier of parts. Delphi would like to renegotiate its deal with General Motors. Under the current deal structure, it's hard to imagine that Delphi could be profitable. Essentially, there are only two possibilities, although it will be some time before we know which will be the operative one. Either Delphi will receive better terms from General Motors, so that each improvement in the terms of trade in favor of Delphi would be a deterioration in the terms that General Motors receives, meaning a diminution of General Motors' profitability or, secondly, since Delphi is in bankruptcy, it

is quite possible that General Motors will be required to assume certain Delphi benefits, as was included in the contract at the time of the Delphi spin-off.

Given its cash position and the remoteness of having to pay those Delphi benefits, General Motors might be able to manage that situation, but I think that the company's deterioration is going to be steady. Even in an economic recovery, General Motors will not be the company it once was.

A merger with Chrysler is a possibility that could have some cost efficiencies, but I don't think it addresses the major problem. The liabilities that the company contracted for outside of the normal employment pay compensation, which are the post-retirement liabilities, are not manageable in the long run. I don't see any alternative other than the continued degeneration of this company into insolvency, although it may take several years for that to occur.

Ford (F)

At the time that I wrote the General Motors report, no mention was made of Ford, but I would say that Ford is in more or less the same circumstance as General Motors. Data on October 2008 industry sales have not yet been released[5], but based on the projections, which appear reasonable, industry sales are estimated to be down 29% from a year ago. If the number is anything approaching that estimate, it's hard to imagine that Ford will be profitable.

Given the balance sheet circumstances of Ford and General Motors, Toyota has made an announcement that I think is brilliant. Toyota announced 0% financing on all of its models, while GMAC and Ford are tightening their lending standards. Given the balance sheet predicaments of GMAC and Ford, it's hard to imagine, as a matter of fact it's actually impossible to imagine, that General Motors and Ford could match what Toyota does. In a declining sales environment it is reasonable to presume that General Motors and Ford are going to lose market share, perhaps permanently.

A reasonable estimate of the annual rate of auto sales for next year might be on the order of 11 million. Making allowance for some loss of market share by Ford and General Motors, however modest, it's hard to imagine how the two companies will be profitable in the next four quarters. It's possible, but it's hard to imagine, which means that, one year from now, the balance sheets will show marked deterioration from their already precarious level.

Though Ford has $42 billion in cash and can manage its near term maturity structure in a manner not radically different from the General Motors situation, it is important to note that Ford has $166 billion of various forms of debt, which is an enormous challenge. It's

[5] This report was recorded on November 3, 2008.

hard to imagine how the company could survive in the long run with a balance sheet of that type.

I'll suggest another way to short Ford. If one were to sell the Ford January 2010 $2.50 call for $0.95, and buy the Ford January 2010 $2.50 put for $1.50 netting out the two positions, one is basically shorting Ford at $0.55. Ford is a little over $2.00 currently. If Ford really went to zero, in theory, one could make four times one's money. In my opinion, that's a superior trade than being short Ford.

From the Readers

Q: *What do you think about position sizing?*

A: At inception, standard position size for me is usually 2%. I don't change it radically over time, because I'm a big believer in the mathematics of what's called self-ordered criticality. Ultimately, if you leave the portfolio alone long enough, whatever your best position is will eventually become your largest position. In other words, let the portfolio do the work.

If you undertake to alter position sizes over time, then you're effectively changing your view of the risk of the enterprise. Given your view of the enterprise, if you thought it reasonable to establish a 2% position, and the company lost half its value, and all else remained constant, if you altered the position to make it a 2% position again then you're effectively making it a 3% position. That should be done if it is concluded that the risk/reward at the lower level is far superior to all the other companies that are in the portfolio. It has certainly happened more times than I care to admit that a 2% position became a smaller percent of the portfolio, because it lost half its value. Usually when that happens to me, I have plenty of other companies that are losing comparable amounts, especially at a time like this, so I usually tend to leave it alone.

Q: *If one were interested in gaining exposure to the energy sector, but was concerned about certain governments, such as Russia, not treating shareholders as partners, would it make sense to buy the oil services, or perhaps alternative energy plays like wind and solar?*

A: From what I can tell, the Russian government has ownership in Gazprom. One could argue whether or not the Russian government thinks of shareholders as partners, but it certainly thinks of the competitors to Gazprom as adversaries. Anyone who's ever examined the position of Yukos Oil, which was one of the largest non-state oil Russian companies, should understand what happened to that company.

I think that if the Russian government was not interested in maximizing the share price of Gazprom, it wouldn't be publicly traded. It *is* publicly traded, because it represents some national objective, the nature of which is unknowable. I don't think that shareholders of Gazprom need to be worried about being disenfranchised, because they are partners with the Russian government. I believe that if one were to invest in a company that competes vigorously with Gazprom, it is not inconceivable that the Russian government could make life for that company very unpleasant. In extremis, I think it's possible that the Russian government might make corporate existence for that company very difficult.

In answer to the part of the question about oil services companies, I've never been a big investor in oil services. The reason is that there are many more oil services companies than there are oil companies that use the services. Clearly, both industries are dependent upon the price of oil for success; however, the oil companies are the consumers of the services provided by the other industry. The world's oil companies, many of which are state owned, are in the position of being monopsonies, which is the situation in which there is one buyer, but a multiplicity of sellers. I believe that the oil companies will do better, as a generalization, than the oil services companies.

That said, there are some very astutely managed oil services companies. Though it's not very liquid, there is one company that I'd like to call the readers' attention to. It's called Siem Industries. It is my belief that the company trades at a big discount to NAV. In addition, I think that the person who manages the company, Christopher Siem, is a brilliant value-based investor. One could make a lot of money on that stock. Unfortunately, I observed on Friday, October 31 that Siem was up 30% for reasons that are beyond my comprehension.

Q: *What is your opinion of Petrobras?*

A: Most oil companies of the world are having great difficulty finding oil and replacing reserves. Petrobras, at least for the last several months, has made some significant discoveries. There's a big discovery in the Santos Basin, and in a field known as Jubarte in Espirito Santo. There is also a field called Jupiter that is 290 kilometers off the coast of Rio de Janeiro. Apparently, there's a lot of offshore oil in Brazil, much of which has yet to be exploited. Essentially, it's Petrobras and its partner companies that will do the exploiting.

At the moment, Petrobras trades at 5x the consensus earnings estimate. That estimate does not appear to be based on a price of $60 per barrel of oil. Perhaps the estimate would be subject to revision if the price of oil remains where it is, or goes lower. Nevertheless, I observed that, as these discoveries were announced over the last several months, the company declined to give very much information about them, because it wasn't in the position, or so it said, to evaluate how large they were. If it merited announcing, it's more likely than not that they were rather big. Therefore, Petrobras is probably an interesting investment. As far as I can determine, it's one of the few companies with the ability to grow its reserves.

Q: *What is the natural revenue growth rate for Goldman Sachs?*

A: We now know that Goldman Sachs is becoming a bank holding company and, as such, it will be regulated much more strictly than it was historically. It's hard to imagine that Goldman Sachs could earn a rate of return even remotely approaching what it earned historically. Therefore, it must logically follow that the natural growth rate in revenue for Goldman Sachs is probably not going to be radically different from the natural business growth rate of, shall we say, JPMorgan Chase. In the fullness of time, the two companies are going to become comparable in their characteristics. They're both very large. JPMorgan, of course, is much larger than Goldman Sachs; nevertheless, both are of sufficient size, and both will be constrained in terms of balance sheet leverage, such that one is not likely to radically outperform the other. All of the bank holding companies are certainly going to be pressed to gravitate towards more conservative, not less conservative, balance sheets.

Q: *Even though banks might be constrained in a balance sheet sense to raise fees on all sorts of products, is it possible for them to have higher returns than might otherwise have been contemplated?*

A: I don't think that there's very much possibility of that happening. At least in the United States, there remains, and will remain, much competition in banking. That competition is directed particularly towards building a stable funding base, which will largely be deposit driven.

Now that Morgan Stanley and Goldman Sachs have become bank holding companies, they basically must completely reconstruct the liability side of their balance sheet, and fund themselves as much as possible through deposits. That's not usually the environment in which one has increasing fees. One usually has either decreasing fees or, alternatively, at least in the short run, a better deal for the customer in terms of the rate paid on deposits.

All one needs is to look at what the major banks are paying for three-month and six-month CDs relative to where Treasury rates are. The rates offered by banks are actually very high; they are clearly competing for deposits. Will there be sufficiently few of them to constitute an oligopoly that could ultimately lower deposit rates and raise fees? It doesn't appear to me that there will be sufficiently few for that to happen.

Wachovia will become part of Wells Fargo in order that Wells Fargo would have a presence in the geographical area where Wachovia was present. Washington Mutual became part of JPMorgan so that JPMorgan would have a presence in the area formerly populated by Washington Mutual. I do not believe that JPMorgan bought Washington Mutual, nor did Wells Fargo buy Wachovia, simply to engage in an act of stasis. It seems fairly predictable that those two enterprises will seek to expand the scope of the franchise within the newly acquired areas and that, to me, logically entails more competition, not less competition.

Q: *Is there a proxy for early-stage delinquencies in GSE's?*

A: I don't know of one, frankly; however, the real question at the GSE's is not what the delinquency number will be, but what the ultimate return on the book of business will be. Fannie Mae, for example, has a market capitalization of not far from $4 billion. It has a book of business that, at the moment, probably well exceeds $3 trillion. If it made only one basis point of return on that book of business, it would be over $300 million. If Fannie Mae could merely earn a one basis point rate of return, it would be trading at a P/E ratio of 11x or 12x. If Fannie Mae could earn a two basis point rate of return it would probably be trading at a P/E ratio of 6x. If it could earn a four basis point rate of return on that business it would probably be trading at a P/E ratio of 2.5x or 3x. If it earned an eight basis point rate of return, it would probably be trading at a P/E ratio of 1.5x. Historically, all of those returns would be very low for Fannie Mae. In order to evaluate that company, we'd have to arrive at a way of determining what might be the ultimate rate of return on such a business, but until we have more data, it's impossible to know.

A: *What is your opinion of Citigroup? Does it have a one-of-a-kind global franchise that acts as a moat, so to speak, and cannot be replicated?*

A: I think ultimately Citigroup will prove to be a profitable enterprise, and will generate a reasonable rate of return for its shareholders. I would not, however, say that Citigroup is a one-of-a-kind, extraordinary business franchise. If I were to compare Citigroup as a business franchise to Goldman Sachs, Morgan Stanley, JPMorgan, Wells Fargo or even Bank of America, I would regard those companies as superior to what we might find in Citigroup today in terms of organization, transparency and balance sheet quality.

Citigroup's growth over the last 10-12 years was not one of organic construction. It was built as it is today via numerous acquisitions and divestitures. It's not entirely clear how all those pieces fit together. One might say the same for Bank of America, which has its roots in NCNB, a company that knew how to consolidate banks.

As for the worldwide business franchise of Citigroup being considered a moat, of all the financial institutions, Citigroup appears to have the weakest balance sheet and the least reassuring level of creditworthiness, whereas investors are going to look for strong balance sheets and high levels of creditworthiness. It doesn't mean that Citigroup's stock price can't double or triple in price (which I believe it will do), but let's not forget that the company was recently selling German assets just to stave off a downgrade in creditworthiness.

By comparison, Wells Fargo, which wasn't engaging in a similar activity, could emerge as the superior franchise. Also, in terms of balance sheet strength, I would have to say that JPMorgan clearly exceeds that of Citigroup. If one were to rank banks in terms of

business franchise, the salient, most valuable feature of a bank in terms of its moat would have to be its balance sheet integrity. Consequently, I would not rank Citibank as my first pick in that regard.

Q: *What are your thoughts on Legg Mason?*

A: At the end of the day, no matter what happens in SIVs, the heart and soul of Legg Mason is the investment management business. It's really a question of the returns that will be produced by the managers for their client base. In that case, we need to look at Royce, Western Asset Management, Bill Miller and the Legg Mason funds, and all of the other managers at Legg Mason. I have no reason to reach any conclusion other than that I believe they'll eventually produce attractive rates of return and they'll have very little difficulty in attracting client assets.

One way or another, the SIV problem will be solved. At the moment, all the company can do is basically chip away at it, which they are doing. It's a resolvable problem. All we can say is that it's less of a problem than it was a month ago. A month from now, it will be less of a problem than it is today. Ultimately, its value will be determined by the returns the fund managers create. I have no reason to believe that they won't create good rates of return. I would buy Legg Mason.

APPENDIX A

Money Manager Index

From Jan 1983 to October 2008

Year	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Yr. End	Index	Yearly return	Annualized return (since inception)
1983								1.00	0.81	0.76	0.87	0.75	1983	0.75	(60.5)%	(50.2)%
1984	0.75	0.71	0.70	0.66	0.67	0.67	0.61	0.83	0.79	0.76	0.67	0.65	1984	0.65	(13.5)%	(26.5)%
1985	0.92	0.93	0.99	0.95	1.20	1.30	1.32	1.38	1.28	1.50	1.86	2.02	1985	2.02	211.8%	33.7%
1986	2.46	2.78	2.47	2.31	2.36	2.33	2.03	2.23	1.98	2.37	2.34	2.34	1986	2.34	15.9%	28.2%
1987	3.21	3.27	3.16	2.55	2.37	2.30	2.39	2.47	2.22	1.56	1.44	1.52	1987	1.52	(35.0)%	9.9%
1988	1.80	1.87	1.78	1.79	1.69	1.94	1.92	1.96	2.01	1.97	1.95	2.07	1988	2.07	36.0%	14.3%
1989	2.42	2.37	2.54	2.63	2.64	2.64	2.93	3.12	3.07	3.05	3.23	3.26	1989	3.26	57.8%	20.2%
1990	3.12	3.15	3.53	3.06	3.47	3.45	3.30	2.70	2.68	2.40	2.52	3.02	1990	3.02	(7.3)%	16.1%
1991	3.08	3.49	3.70	3.68	3.71	3.61	3.86	4.05	4.07	4.69	4.47	5.72	1991	5.72	89.4%	23.0%
1992	5.76	5.61	5.30	5.12	4.98	4.99	5.93	6.06	6.19	6.56	7.25	7.36	1992	7.36	28.6%	23.6%
1993	8.06	8.04	8.20	7.94	8.15	8.57	9.05	10.00	9.99	9.31	8.97	8.90	1993	8.90	21.0%	23.4%
1994	9.52	8.73	8.05	7.85	7.81	7.53	7.66	8.31	8.15	8.52	7.88	7.95	1994	7.95	(10.6)%	19.9%
1995	7.74	8.38	8.72	8.77	9.20	9.35	9.93	10.78	11.22	10.53	10.89	10.40	1995	10.40	30.8%	20.8%
1996	11.12	11.50	11.33	11.62	11.86	12.53	11.91	12.36	13.32	14.03	14.42	15.02	1996	15.02	44.4%	22.4%
1997	16.04	16.81	15.32	17.27	18.42	20.29	22.28	21.39	25.31	24.95	24.95	25.50	1997	25.50	69.8%	25.2%
1998	25.67	29.00	29.89	30.60	28.90	30.44	27.67	21.33	21.74	25.16	27.27	25.41	1998	25.41	(0.4)%	23.3%
1999	26.00	23.71	23.92	26.77	28.94	29.74	28.78	26.74	25.89	27.73	28.54	30.55	1999	30.55	20.2%	23.2%
2000	31.07	31.19	36.01	35.60	35.20	40.32	43.58	45.75	45.62	48.69	44.05	49.84	2000	49.84	63.1%	25.2%
2001	50.23	46.41	44.27	46.96	48.90	49.98	50.67	49.70	46.47	44.81	48.04	51.91	2001	51.91	4.2%	23.9%
2002	53.62	53.74	55.11	52.52	52.83	50.48	42.58	44.92	41.54	42.66	45.78	43.17	2002	43.17	(16.8)%	21.4%
2003	42.72	41.18	42.36	45.98	49.02	50.71	53.47	53.97	53.46	56.12	55.83	58.49	2003	58.49	35.5%	22.1%
2004	64.38	65.08	64.63	61.68	60.86	62.30	58.71	64.08	65.73	68.86	73.53	78.16	2004	78.16	33.6%	22.6%
2005	76.46	77.94	74.06	72.83	77.02	80.25	83.59	83.07	86.03	89.19	96.58	97.35	2005	97.35	24.6%	22.7%
2006	107.62	111.44	110.75	111.88	101.89	100.61	100.62	104.98	114.61	116.64	113.78	118.05	2006	118.05	21.3%	22.6%
2007	125.73	123.77	122.62	127.58	133.57	134.68	126.61	124.07	133.57	148.09	135.13	135.56	2007	135.56	14.8%	22.3%
2008	127.53	115.76	115.94	121.58	130.51	115.68	119.94	120.55	109.69	72.70			2008	72.70	(46.4)%	18.5%

Name	Amount Invested	Name	Amount Invested
Affiliated Manager	$ 22,947	Pzena Investment Mgt	$ 122,426
Alliance	$ 7,633		
BlackRock	$ 23,205		
Waddell & Reed	$ 27,513		
Eaton Vance	$ 2,641		
T. Rowe Price	$ 2,423		
Franklin resources	$ 908		
Legg Mason	$ 1,000		
Federated Inv	$ 26,381		

APPENDIX B

International Money Manager Index

From Jan 1983 to Oct 2008

Year	31-Jan	28-Feb	31-Mar	30-Apr	31-May	30-Jun	31-Jul	31-Aug	30-Sep	31-Oct	30-Nov	31-Dec	Yr. End	Index	Yearly return	Annualized return (since inception)
1986											1.00	1.02	1986	1.02	10.0%	10.0%
1987	1.25	1.37	1.48	1.48	1.37	1.33	1.39	1.40	1.33	0.81	0.76	0.73	1987	0.73	(27.7)%	(23.3)%
1988	0.75	0.92	1.02	0.95	0.80	0.89	0.88	0.82	0.86	0.88	0.89	0.93	1988	0.93	26.4%	(3.4)%
1989	1.03	1.02	1.06	1.17	1.19	1.18	1.25	1.16	1.17	1.20	1.21	1.28	1989	1.28	37.8%	8.1%
1990	1.24	1.24	1.18	1.19	1.22	1.24	1.26	1.26	1.23	1.24	1.25	1.33	1990	1.33	3.7%	7.0%
1991	1.34	1.52	1.56	1.58	1.57	1.47	1.52	1.64	1.81	1.89	1.94	1.92	1991	1.92	44.8%	13.5%
1992	2.01	1.93	1.88	2.14	2.19	2.13	2.08	1.99	1.95	1.77	1.76	1.96	1992	1.96	1.9%	11.5%
1993	1.98	2.03	2.20	2.39	2.42	2.45	2.54	3.05	3.01	3.07	3.01	3.30	1993	3.30	68.7%	18.1%
1994	3.72	3.39	3.17	3.04	2.99	2.89	3.01	3.14	3.13	3.19	3.15	3.15	1994	3.15	(4.7)%	15.1%
1995	3.07	3.12	3.28	3.41	3.56	3.59	3.87	3.76	3.76	3.77	3.70	3.73	1995	3.73	18.6%	15.4%
1996	3.76	3.85	3.70	3.79	3.96	3.90	3.75	3.96	4.16	4.47	4.90	4.86	1996	4.86	30.3%	16.8%
1997	5.11	5.37	4.99	4.96	5.43	5.94	6.57	6.32	7.45	7.24	6.80	7.19	1997	7.19	47.9%	19.3%
1998	7.12	8.05	8.78	9.25	8.95	8.74	8.91	6.67	6.08	7.01	7.51	7.71	1998	7.71	7.3%	18.3%
1999	7.99	8.21	8.68	9.07	8.71	8.61	8.63	8.43	8.47	8.79	9.80	10.79	1999	10.79	39.9%	19.8%
2000	11.23	12.27	13.95	13.50	13.73	15.39	15.85	16.82	17.07	16.31	14.43	16.76	2000	14.43	33.8%	20.7%
2001	17.42	15.88	13.46	15.14	15.84	15.15	14.21	13.61	10.77	11.43	13.90	14.12	2001	14.12	(2.2)%	19.1%
2002	14.74	13.78	15.09	15.11	16.38	14.14	12.92	12.10	11.23	11.06	11.33	10.50	2002	10.50	(25.6)%	15.7%
2003	10.18	9.52	9.69	10.62	12.17	13.04	13.98	15.38	16.67	17.88	18.16	18.07	2003	18.07	72.1%	18.4%
2004	20.00	22.41	29.98	35.46	26.68	30.80	25.37	25.20	23.67	23.34	27.56	31.48	2004	31.48	74.2%	20.9%
2005	32.19	32.57	31.88	27.79	27.36	29.05	30.38	31.49	33.39	32.24	32.95	37.18	2005	37.18	18.1%	20.8%
2006	41.01	40.97	43.69	46.45	42.39	41.58	40.60	43.32	43.55	43.70	44.58	49.38	2006	49.38	32.8%	21.3%
2007	50.95	51.18	53.59	56.09	58.16	56.37	53.90	48.65	50.96	57.03	48.21	45.75	2007	45.75	(7.3)%	19.8%
2008	38.71	39.71	38.59	40.18	39.25	35.10	34.59	33.33	26.09	18.72			2008	18.72	(59.1)%	14.2%

Name	Amount Invested	Name	Amount Invested	Name	Amount Invested
IGM FINANCIAL INC	$1,000	HENDERSON GROUP PLC	$14,447	BLUEBAY ASSET MANAGEMENT/UNI	$37,469
F&C ASSET MANAGEMENT PLC	$1,203	RAB CAPITAL PLC	$24,603		
INVESCO PLC (PREVIOUSLY AMVESC	$1,357	AZIMUT HOLDING SPA	$21,908		
SCHRODERS PLC	$1,208	AUSTRALIAN WEALTH MANAGEMENT	$27,789		
RATHBONE BROTHERS PLC	$1,208	EVEREST BABCOCK & BROWN LTD	$23,437		
ABERDEEN ASSET MGMT PLC	$1,208	NEW STAR ASSET MANAGEMENT	$27,700		
CI FINANCIAL INCOME FUND	$2,585	CHARLEMAGNE CAPITAL LTD	$36,848		
MAN GROUP PLC	$2,862	PARTNERS GROUP-REG	$36,848		
AGF MANAGEMENT LTD-CL B	$3,343	INVISTA REAL ESTATE INV MNGT	$36,589		
SPARX GROUP CO LTD	$11,762	ASHMORE GROUP PLC.	$36,688		