

The following is an excerpt from the Annual Report of the Capital Income Builder for the year ended October 31, 2008:

Just before Halloween in 1987, the head of research for Capital Research and Management Company at the time, George Miller, gathered the company's investment professionals for a meeting. The mood was somber, to say the least. The Dow Jones Industrial Average had fallen 22.6% on October 19 [1987], the worst single-day percentage loss since the Great Depression, and the rest of the previous week had been little better.

"George wanted to drive home the point that these things can happen; they've happened before and they'll happen again," recalls Joyce Gordon, portfolio counselor and president of Capital Income Builder. Miller asked everyone to write down what they'd learned, instructing them to seal their observations in an envelope that was only to be opened if needed.

Now, 21 years later, it was time.

The Dow had fallen 24.7% from September 30 through October 27, with mounting concerns over the nation's financial system creating record volatility. Joyce went looking for her envelope and asked those colleagues who were present for the 1987 crash to find theirs as well. The observations they found inside were prescient.

- The market frequently overshoots on the upside and overreacts on the downside.
- In a period of waning confidence, eventually all sectors [of the economy], companies and stocks get hit.
- Liquidity will always be an issue in times of difficulty.
- In the long run, the market will value stocks fairly. In the short run, expect wide discrepancies.

"It was a useful exercise," Joyce says. "We recognized that we had been here before and that we would work our way through it again."¹ The general conclusion was that markets tend to move in cycles of boom and bust. "You always have risks, no matter what phase of the market you're in," states Darcy Kopcho, one of the fund's portfolio counselors. "When stocks are up, there's the risk you're paying too much for them, or that the gains are unsustainable. When they're down, you risk missing the chance to buy before the markets go up again. Markets, as a whole, can be great predictors of what's to come. But they never get it exactly right. They nearly always overshoot and overcorrect."²

The opinions referenced are as of the date of publication and are subject to change due to changes in the market or economic conditions and may not necessarily come to pass. Past returns are no guarantee of future results.

¹ Capital Income Builder Annual Report, October 31, 2008; p. 7

² Ibid, p. 8

A Tale of Two Markets

In Charles Dickens' 1859 classic A Tale of Two Cities, the famous opening line reads "it was the best of times, it was the worst of times." There can be no doubt that this is one of the worst economic times in decades. At the same time, we may end up looking back years from now and view this as one of the best times to have purchased stocks.

In a normal market environment, investors could generally rely on two distinct markets—stock market and bond market. When the stock market is down, typically the bond market is up and vice-versa. As we now know, 2008 was far from a normal market environment. In fact, the two markets that seemed to exist last year were the Treasury market and everything else. Fear was everywhere—in the stock market, the bond market, in the U.S., Europe, Latin America, even Asia. The sentiment was so widespread, there truly was nowhere to hide. The lone refuge was government Treasuries in which investors were not so much concerned about return on capital as they were about *return of principal*. The government couldn't issue Treasuries fast enough. At one point, investors were paying the government (in the form of negative interest rates) to hold their money. In fact, I wouldn't be surprised if one of the most-searched terms on Google at the time was "fire-proof mattress".

The cause of the credit crisis that gripped the world's financial system in 2008 can be traced back to the boom and bust of the housing market and the corresponding rise in subprime mortgages that began in 2003.³ Both were fueled by prolonged low interest rates and easy access to credit by consumers and investors. "The ability of virtually anyone to get a loan to buy a house pushed up home prices significantly higher than incomes."⁴ Subprime loans were packaged and sold as investments to financial institutions around the world. "When prices are rising no one needs to default, they always have the option of refinancing or selling the house at a higher price. But when prices are dropping, there is no easy way out. The result has been a sharp rise in delinquencies and foreclosures as the bust has played out."⁵ As billions of these mortgage-related investments went bad, the financial health of many banks came into question and eventually froze lending among institutions and to consumers. The consequence has been a severe loss of confidence among consumers and businesses and a global recession.⁶

Another dynamic that made a bad situation worse was the banks' initial reluctance to raise capital. Typically new money is raised from outside investors such as private equity firms and sovereign wealth funds. This reluctance stemmed from fear of diluting their existing shareholders. As a result, the self-serving thing to do was to avoid the dilution and hope for conditions to improve. "What may be sensible for each institution individually may collectively be a bad idea."⁷ This may seem like an instinctively good move for one company, but if all institutions behaved similarly, it eventually leads to the deterioration of trust among companies.

³ American Funds: 2008 Review/2009 Outlook

⁴ "Financial Market Turmoil: The Federal Reserve And The Challenges Ahead" by William C. Dudley, President, Federal Reserve Bank of New York, March 6, 2009

⁵ *ibid*

⁶ *ibid*

⁷ *ibid*

In our September 2008 Commentary titled “Q&A Regarding Recent Market Volatility” (www.cap-partners.com/news.htm), we explained why this current crisis differs from the Great Depression. Even though the current economic environment is as severe as anyone in the U.S. has experienced since the 1930s, “financial crises occur with surprising frequency—in every decade in the past century there has been at least one big shock to a major economy’s financial system.”⁸ In 1982, there was the Latin American debt crisis. The early 1990s ushered in Japan’s “lost decade”. In 1995, Mexico was on the verge of defaulting on its debt had the U.S. and the International Monetary Fund (IMF) not stepped in to help. In the late 1990s, the Asian financial crisis began in Thailand and ended up affecting every other major economy in Asia including Russia, South Korea, and Indonesia.⁹

In spite of the fact that the credit crisis originated in the United States, the U.S. stock market (as represented by the S&P 500 Index) was down 37% for the year, while all other major economies’ stock markets from Australia (-50%), Brazil (-56.1%), and China (-50.8%) to Germany (-45.5%), Mexico (-42.9%), Russia (-73.8%) and the United Kingdom (-48.3%) fared worse than the United States.¹⁰ Japan (-29%) was the only major economy that had a better relative return than the U.S. The current global recession marks the first time in over 60 years that the major economies of the world were in recession simultaneously. Not only was there no place to hide from the standpoint of asset classes (stocks, bonds, or real estate), but there was also no place or country that was immune from the global downturn.

Knowing how the major stock markets of the world fared in 2008, let us look at the results of the CAP Partners sample portfolio which averages all the returns of the funds on our Core List¹¹ with equal weighting for each fund versus the S&P 500 Composite Index:

Index	1 Year	3 Year	5 Year	10 Year
S&P 500	-37.00%	-8.36%	-2.19%	-1.38%
CAP Partners Core Equity Portfolio	-37.29%	-7.41%	0.08%	3.82%

*Results are as of December 31, 2008

In the short term (one year), the aggregate portfolio trailed the market by one third of 1%. Over longer periods, however, the sample portfolio has outpaced the market. The difference becomes significant when you look at the 10-year returns in which the portfolio outperformed the market by 5.2%. The numbers are meaningful when you look at the impact of 5.2% over ten years. A \$10,000 investment over the last ten years in the S&P 500 Index would have resulted in a value at the end of 2008 of \$8,702.62. Consequently, \$10,000 invested in the CAP Partners Core Equity Portfolio over the same ten years would have a value of \$14,548.23 at the end of 2008. This translates to a \$5,845.61 difference or a 40.2% greater value.

⁸ “Financial crises, past and present” The McKinsey Quarterly, December 2008

⁹ Rubin, Robert, “In An Uncertain World”

¹⁰ American Funds: 2008 Review/2009 Outlook

¹¹ A complete list of core mutual funds employed in client portfolios can be found on our website, www.cap-partners.com/investment.htm

The previous example is not much comfort to investors who invested in the last one, three or even five years, especially when the value of their account has decreased over one third in the last twelve months. So, let me provide an analogy that most people can relate to—as stocks and bonds are not as tangible an asset as real estate and most investors and clients have had experience purchasing a house. I should also mention that for investors with a time horizon of less than two to five years, our October 2008 article titled, “Investment Strategies in a Bear Market” (www.cap-partners.com/news.htm) describes specific strategies based on each investor’s investment objective.

A Real Estate Analogy for Stock Investors

Imagine that you purchased your house four years ago (2005) for \$200,000,¹² and that you purchased it because you liked the floor plan, the neighborhood, and envisioned living in it for the foreseeable future. You did not, however, purchase the house with the intent of selling it in a year or two to simply try to capture a profit. Imagine then, two years later (2007) that someone knocks on your front door who likes the look of your house and is willing to make you an offer to buy it for \$270,000. At the time, credit was readily available and interest rates were still low based on historical standards. Furthermore, this potential buyer was quite eager to buy your house as is.

If you were to sell, you could pocket approximately \$70,000 in profit and realize a 35% return in two years—not bad. Upon further analysis, you realize that if you were to sell, you would have to move and buy another house to live in. This would entail incurring moving costs and, more importantly, you would be buying a comparable house at prices much higher than you bought your original house. After additional calculations, you come to the conclusion that you may not necessarily pocket \$70,000 or a 35% return as a result of moving costs and higher housing prices. Furthermore, you remind yourself that you were not looking to sell in the first place, and that you like the house you’re living in. Most importantly, you don’t need the money. As a result, you decline the buyer’s offer.

Fast forward another two years to today (2009). Now imagine a second buyer knocking on your door, and is offering to buy your house for \$144,000 or \$56,000 less than what you paid for it four years ago due to falling housing prices. Because this buyer has the resources (cash) to buy property at a time when credit is scarce and banks are unwilling to lend to even the most creditworthy borrower, the buyer is capitalizing on a surplus of inventory or what is commonly referred to as a buyer’s market. Knowing that you had an offer for your house for \$270,000 as little as two years ago, you perceive the offer as an insult and summarily slam the door on the buyer’s face. You dismissed the offer because you have confidence in the quality of the construction of your house and more importantly, you don’t need the money.

You recognized that you ignored the bid (offer) you received from the buyer since it was too low, and that you didn’t need the money just as you ignored the bid you received from the first buyer two years ago for the same reasons. Ultimately, you ask yourself “did it really matter that my house was worth \$270,000 two years ago?” Furthermore, “does it matter that

¹² The home owner’s scenario is based on a \$160,000 mortgage for 15-years, at 5% fixed (with a 20% down payment or \$40,000).

someone is offering me only \$144,000 today if I am not looking to sell and I don't need the money?"

Now imagine, on the other hand, that you were recently laid off from your job like many others in this recession and may even be on the verge of foreclosure. In this situation, you might seriously consider selling at that depressed price and not haggling because of the need to pay off the mortgage before the bank forecloses on it.¹³ Furthermore, if you have concerns about the quality of the construction of your house, you may want to take the offer of \$144,000 for fear that the long term value of the house will continue to decline as costs for repairs will surely mount.

However, knowing that you are not in this situation, you do not need to act as if you are. This is critical because when values are down most investors *behave* as if they are desperately in need of the money when in reality they are not. By reminding yourself that you are not in a desperate situation, you avoid committing a disastrous mistake of accepting a low unsolicited bid. You remind yourself that time is on your side because you are not looking to sell, and you will simply wait for conditions to improve over time until you receive a bid (offer) worthy of your asset.

The "Fix Is In"

One of the ways to determine the best course of action in solving the current economic situation is to look at how other countries and economies addressed past crises. In December, the global research firm McKinsey & Company published an article entitled "Financial Crises, Past and Present". From their studies, they concluded that one of the lessons learned from past episodes was that recovery "depended, critically, on the way governments acted to recapitalize the banking system and to restore stability and confidence."¹⁴ In the last nine months, there have been numerous programs and initiatives enacted by the Federal government to attempt to address the financial crisis.

The list of programs and initiatives¹⁵ include:

- Troubled Asset Relief Program (TARP)
- Term Auction Facility (TAF)
- Term Securities Lending Facility (TSLF)
- FDIC's Temporary Guarantee Liquidity Program
- Commercial Paper Funding Facility (CPFF)
- Term Asset-Backed Security Loan Facility (TALF)
- Public-Private Investment Fund (PPIF)

The number of programs initiated and their combined scale in dollar terms (now approaching \$2 trillion) reflects the severity of the crisis. With unemployment reaching 8.5%, over 13 million Americans are now out of work. The foreclosure rate is climbing, and housing prices nationwide are down an average 19% over the past year. In 2008, 25 banks failed. Through

¹³ The mortgage balance four years (48 months) into the loan would be approximately \$127,535.

¹⁴ "Financial crises, past and present" The McKinsey Quarterly, December 2008

¹⁵ Federal Reserve, Department of the Treasury

the first three months of this year the FDIC has already taken over 21 banks. The list of bad news is extensive. Yet, signs of improvement are visible.

Today banks have plenty of access to liquidity via the Term Auction Facility or TAF in which funds are auctioned off to banks. The Term Securities Lending Facility (TSLF) allows banks to borrow Treasuries from the Federal Reserve enabling them to increase their lending capability. The Commercial Paper Funding Facility or CPFF has successfully helped restore the commercial paper market, which is the primary method in which corporations fund their payrolls. The most recent program announced by the Treasury Department is the Public-Private Investment Fund (PPIF). This facility, funded by TARP, is designed to purchase illiquid and distressed assets from financial institutions with the participation of private investors. With this program, the private sector now has the opportunity to participate and contribute to the economic recovery.

Despite the progress being made, it will continue to be a long road ahead. The consequences of these stimulative efforts will be reflected in higher inflation and interest rates in the next several years.

Portfolio Updates

One of the (good) challenges facing investment advisers in this current market downturn is the abundance of investment ideas. Our task lies not only in choosing which companies to buy, but also which companies to sell in order to buy. Since there is no shortage of investment opportunities, in the last six months we have had to make a comparative analysis of all clients' individual security holdings. The analysis seeks to determine whether it is better to still own a specific company, or sell it and buy a healthier, faster growing company at a cheaper price.

For example, we recently sold several companies in the retail and manufacturing sectors that we believe will continue to have difficulty growing in the current environment. In the past few months we have sold our positions in Disney, Home Depot, Seagate Technology, Starbucks, Toyota Motor, Whole Foods Market, and Yahoo. In several of these positions (Disney, Seagate, Toyota), we were able to still sell at a profit despite their share price having fallen dramatically. We were not as fortunate with the other positions, but it allowed us to buy and add shares in Berkshire Hathaway, Brazilian Petroleum Corporation (Petrobras), Exelon, Nestle, Procter & Gamble, and Visa.¹⁶

The fact that 2008 was the first calendar year since 2002 that the market was down, provided an opportunity to sell positions (in taxable accounts) and capture losses for tax purposes. Once a position is sold, it enables us to reinvest the proceeds into our new, and hopefully, better ideas. We will continue to sell positions that have unrealized losses to capture for tax purposes in 2009. By doing so, we will be able to apply these tax losses to gains that we anticipate in the next few years as the market recovers without incurring capital gains taxes.

¹⁶ Description of positions sold and bought do not apply to all accounts, since client portfolios are constructed uniquely based on each clients' investment objective, risk tolerance, investment experience and investment time frame.

Unfortunately, not all positions that we sold were for purposes of capturing tax losses. In a time of financial crisis, the government takes an activist role that affects whole industries, not just individual companies. In this instance, financial institutions were widely affected. To that end, we incurred substantial losses when we sold all our clients' positions in Citigroup once we determined that the Treasury department would convert their preferred shares in the company to common stock. This would have the effect of making the Treasury's stake in the company as much as 40%, and dilute the shares that we owned.

We make the utmost effort to avoid selling a position at a loss unless we either have a much better investment idea or we determine that the upside potential for owning the stock (relative to the inherent risk) no longer exists, as was the case with Citigroup. It is our hope that these occurrences are the exception to the rule rather than the norm. At the same time, we are very excited about the prospects of the companies we have been able to buy at the prices we've seen.

In the nine months since the financial crisis ensued, a shift has occurred in our assessment of companies in identifying investment opportunities. Prior to the recession, our assumptions were based on the economies of the world expanding and companies' earnings growing. Thus, our search for investments focused on finding quality companies at attractive prices since we accepted that their earnings would continue to grow. That is no longer the case.

Today, our assumptions are based on the fact that virtually every single company's stock is trading at not only attractive prices, but prices that haven't been seen in over ten years. In fact, some companies are selling in the market at less than the total value of what their assets (inventory, real estate, patents, factories, etc.) could fetch in a liquidation (book value). Our search is now focused on companies whose products and services are still needed, especially during a recession, and have the ability to raise prices and grow earnings. These companies must also possess a solid balance sheet with excess cash to weather the downturn and not be dependent on the credit markets to finance their short term operations. We have found several and continue to identify such companies.

At the beginning of the year, we began buying shares in two of the largest agricultural mining companies, Potash Corporation of Saskatchewan and The Mosaic Company. Both companies mine three primary plant nutrients (fertilizer): potash, phosphate and nitrogen.¹⁷ Potash is a mineral mined from underground deposits left behind millions of years ago by evaporated seas. The world's largest known deposits are in Saskatchewan, Canada.

With the world's population approaching 7 billion and estimated to exceed 9.5 billion by 2050¹⁸, the ability of governments and societies around the world to feed their populations will be challenged. The number of acres of arable land (farm land) in the world is decreasing as a result of residential, commercial and industrial development. The most cost-effective approach to feeding the growing population will come from increases in crop yields brought about by the use of fertilizers. We believe Potash and Mosaic will benefit from this continuing trend over the long term.

¹⁷ Source: Potash Corp.

¹⁸ Source: U.S. Census Bureau

One company that we have monitored the last three years, but whose stock we have not been willing to buy for fear of overpaying—until now—is Google. As a result of the overall market's decline, Google's stock has fallen over 50% in the last year, while its earnings have continued to grow. With Yahoo's recent struggles to position itself as a solid #2 in internet search, and Microsoft's inability to consummate a deal with Yahoo, Google's acquisition last year of DoubleClick increased its dominance of the online advertising market to a 70% market share¹⁹. We believe the company has the resources and talent to continue growing its earnings in the next several years.

As a result of the economic stimulus bill that was passed earlier this year, spending on infrastructure for the improvements of roads, bridges and highways will benefit specific companies in this sector. One company we've identified is Jacobs Engineering. They are one of largest providers of engineering, construction and maintenance services to oil and gas, chemical, and pharmaceutical companies and the U.S. federal government. We believe the company will be an integral part of the infrastructure efforts now underway.

Early last year, InBev, the Belgian-Brazilian beverage company, and the maker of Bass and Beck's brand of beer, announced their intention to buy Anheuser-Busch, the maker of Budweiser, for \$70 a share. This type of investment strategy is referred to as arbitrage. The way arbitrage works is that if you believe the merger will go through and you are able to buy the stock at less than the price offered for the acquisition, then you will receive the acquisition price if and when the merger is closed. At the time of our purchase in October, we were able to buy Anheuser-Busch's stock at \$60 a share, and received \$70 a share in cash when the transaction closed three weeks later. In some mergers, you receive the stock of the acquiring company instead of cash. We anticipate more arbitrage opportunities as more companies seek to acquire their competitors to gain market share.

It is often said that no one rings a bell when the market reaches its high, just as no one signals when stocks have hit their lows.²⁰ Staying the course is crucial, and we are doing our best to position clients' portfolios for better market days—whenever they arrive. In these difficult times, we want to thank you for your continued commitment to long-term investing.

Thomas F. White
Managing Partner
CAP Partners, LLC

April 8, 2009

¹⁹ Source: Search Engine Journal, March 2008; Google

²⁰ Fundamental Investors Annual Report ending December 31, 2008