



HOWARD,  
BARCLAY

January 27, 2009

Dear Client,

Reflecting on 2008 I think the only good thing that can be said about it is that we survived the year. We certainly suffered our share of bumps, bruises and broken bones but here we are and as the President Obama said in his inaugural speech

*“We must pick ourselves up, dust ourselves off and begin again the work of remaking America”*

In a year that saw the TSX decline 33%, the S&P 500 down 38.5% and our equity portfolios down in a similar range, the task ahead seems quite a bit more difficult than the president portrayed in his speech.

We would agree with the many market strategists that the current investing environment may be the worst since the Great Depression (which was approximately 80 years ago). All around us the world seems to be falling apart. In the last quarter of 2008, we saw almost unprecedented failures or near failures in the world banking industry. In the cases where banks appeared to be going bankrupt, we basically saw the nationalization of some of the world's largest financial institutions. Companies such as Citigroup, Royal Bank of Scotland and Bank of America were given large capital injections by governments that rendered shareholder value a fraction of what it was prior to the government stimulus. We were witness to watching Lehman Brothers go bankrupt and Bear Stearns rescued just before it was to file for bankruptcy. Merrill Lynch, Wachovia Bank, and Washington Mutual were all purchased by larger financial institutions at significantly lower prices than most analysts would have ever have imagined in order to allow all three to avoid going bankrupt or need some type of government assistance to continue operating. Finally, AIG insurance a company included in the Dow Jones Industrial Average virtually imploded right before us.

These series of events and other similar financial distressed situations that I have not mentioned happened over such a short period of time that investors and government officials have had little time to react. Very few individuals predicted the unraveling of the financial system both in terms of its swiftness and its magnitude. Those that did were forecasting it would occur over several years rather than several months. What is truly remarkable is that the lending that occurred and derivative products that lead to the financial chaos developed over a number of years basically went unnoticed or was ignored. As long as real estate prices continued to increase every year and interest rates remained low the debt lending party was allowed to continue. Amazingly, it seems that most analysts, economists and investors realized over night and at the same time that

there were many financial institutions within the financial system that were a house of cards that simply had to collapse and did.

The events described are very unsettling and now the impact is being felt by mostly all companies and individuals. We see company layoffs, consumer confidence at very low levels, factory utilization numbers falling and a virtual freeze in the lending markets. This can be highlighted by the fact that in December we saw the interest rate of 3 month US treasury bills go negative. Simply put, individuals and institutions were paying the US government to hold their money as they would receive back less money than their principal at maturity. In our opinion this sums up how terrified investors have become.

Going forward there are many other issues to be concerned about but two in particular concern us the most. The first major concern is the eventual outcome for the Big Three North American auto companies. All three have or will most likely require government bailouts in order to survive or have consolidation among them that would most likely lead to large lay-offs and other cost cutting. The number of good paying jobs these manufacturers create and the run-off jobs have a significant impact on the economy and consumer confidence in general. The future of the auto industry (whatever that is) has to be dealt with sooner rather than later.

The second concern we have is the unfunded pension liability that many companies now have. Our concern here is two fold. The first issue is companies that have filed for bankruptcy protection (such as Nortel) or companies that may go bankrupt (such as General Motors). In either case, workers who are retired or nearing retirement may not have the pension income they were relying on. This uncertainty will continue to cause uneasiness in consumer confidence which is likely to cause less spending. The other concern is that although many companies will not go into receivership the billions of dollars in unfunded pension plans will have to be paid from company's earnings. Although government legislation has lengthened the time to make up for the liability from 5 years to 10 years the impact on earnings is likely to be significant. Lower earnings will translate into lower stock prices and prolong the recovery in the stock market.

The brief summary of the last 6 months does not paint a pretty picture and nor should it. However, the hand has been dealt of which we cannot do anything about but it now becomes how do you play that hand. We would all like to see some type of stability in the financial markets. Investors are very unhappy about the losses they have endured but it is difficult to make many financial decisions when there is a sense that their net worth could continue to drop and maybe significantly. To overcome this, we see governments increasing spending on infrastructure and Troubled Asset Relief Program (TARP), maintaining interest rates at historic lows for the foreseeable future, and reducing personal and corporate taxes. The effect of this stimulus will take time but there is unprecedented unified government cooperation world wide that we feel we likely produce positive results for the economy.

Once we have reached a bottom in the market which we feel is close and get the stability we feel is needed we are of the opinion that the market will endure a slow bumpy recovery. Our thinking is the recovery in the market will be slow for the following reasons:

1. Investors now have a more refined definition of risk. Prior to the current collapse investors were aware that markets went down but the thinking was they tended to come back quickly and declines would not be of a great magnitude. Now investors have witnessed that although remote large declines happen and recoveries do not always occur quickly.
2. Since investors have a new sense of risk they will be altering their asset mix going forward. In previous years investors viewed interest rates on bonds as too low to meet their needs and invested more in equities for capital appreciation to earn income. Now bonds will be seen more to prevent losses and the interest rate they earn will almost be secondary.
3. In order for investors to reach their new asset mix they may be inclined to defer any selling at current prices. However, in the short term stock market rallies will be met with selling by investors as they switch asset classes from equities to bonds.
4. Finally the baby boomers that control a large portion of the wealth are generally near the end of their working years. Most baby boomers still had 15 to 20 years to work after the crash of '87 and felt confident about rebuilding their wealth. Now 20 years older they are retired or nearly retired and they cannot make up for losses by working or feel they have a long enough investment time horizon to make up for losses in the market. This could lead to a more conservative asset mix.

What does this mean for Howard, Barclay investors? We feel that investors have become ultra conservative and this is reflected in the price of equities. P/E ratios have been reduced significantly and dividend yields are at levels that we have not seen in a long time. Oddly enough investors are more hesitant to invest in the market now after a 30% to 40% decline than they were a year ago. We view the decline now as an opportunity with equities having declined by such a large extent there is actually less risk than a year ago. Governments and company executives have a better understanding of what they are dealing with and the appropriate steps are being taken to get the economy on stable footing again. We feel the worst is behind us and rather than look in the rear view mirror we are looking ahead at what will eventually be better times.

Sincerely,

Stephen Sisokin,  
President