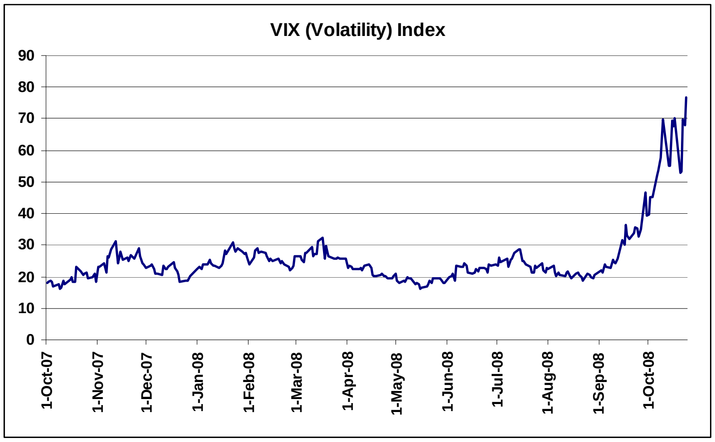
It's darkest before dawn…

Summary

- Volatility in the markets is at historically high levels, fuelled by panic and fear. Redemptions from hedge funds and mutual funds put further downward pressure on stocks as the funds are forced to sell assets to generate cash.
- Ben Bernanke of the US Federal Reserve, the US Treasury and other governments around the world are working hard to restore market normality and invest in financial companies.
- Companies are still growing their earnings – although fourth quarter growth is expected to be more subdued as the economy slows down.
- Investment managers are acquiring good quality companies at attractive prices and reexamining their portfolios in order to withstand current market volatility and prosper in the future.
- Quadrant is taking action in several ways to serve you and your investment goals.

A bit crazy



It has been a bit crazy out there lately. Daily stock market movements used to be a couple of percent (or less) per day, but over the last month, the market had moved two or three times that per day – sometimes with near lightning speed. For example, one day Murray walked out of his office and went down the hall, and the Dow Jones was up a couple percent. By the time he reached another office, a mere 50ft. (15m) away, the Dow had turned negative. Volatility, as measured by the US VIX index or the Canadian Implied Volatility Index (MVX), is at historically high levels and about double the long-term averages. Has all sense left the markets and the economy for good? The answer is no. Will markets settle down and will there be a recovery? The answer is yes.

One of the contributors to the daily volatility that has not been seen in previous market downturns is redemptions by hedge funds and mutual funds. Investors pulled an estimated $31 billion out of hedge funds at the end of the third quarter, shrinking the industry's assets by 11% to $1.72 trillion, according to Chicago-based Hedge Fund Research. Redemptions have forced hedge funds to sell into market rallies, often placing trades near the end of the day and driving down prices at the market close. These funds continued to raise cash into October in advance of further anticipated redemptions.

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The US Fed and Treasury get involved

Since our last report to you in August, the global sub-prime mortgage / credit crisis accelerated. The reasons for this are complex. In his comments to the US Senate, Ben Bernanke, Chairman of the US Federal Reserve summarized the core issues[1]:

> Let me start with the question, why are financial markets not working? Financial institutions and others hold billions in complex securities, including many that are mortgage-related. I'd like to ask you for a moment to think of these securities as having two different prices.
>
> The first of these is the fire-sale price. That's the price a security would fetch today if sold quickly into an illiquid market. The second price is the hold-to-maturity price. That's what the security would be worth eventually when the income from the security was received over time.
>
> Because of the complexity of these securities and the serious uncertainties about the economy and the housing market, there is no active market for many of these securities, and thus today the fire-sale price may be much less than the hold-to-maturity price. This creates something of a vicious circle. Accounting rules require banks to value many assets at something close to a very low fire-sale price rather than the hold-to-maturity price, which is not unreasonable in itself, given their illiquidity.
>
> However, this leads to big write-downs and reductions in capital, which in turn forces additional sales that send the fire-sale price down further, adding to pressure.

In October 2008, the US Congress passed a rescue plan that allows the US Treasury to buy the illiquid mortgage-related assets from banks at a price higher than what they may be worth in today's market (something more than the fire-sale price) and then hold them until an orderly market returns or until maturity. For example, if you were absolutely forced to sell your car, you would probably receive the truer value of your car if you had a month to sell it as opposed to one day. The US government is facilitating an orderly market to allow assets to be sold nearer to their true valuation.

With the US government intervention and that of governments around the world, focus has been on the orderly flow of credit or, more specifically, the lack thereof. The lack of liquidity has left banks and others extremely leery to lend each other money, even overnight. If banks aren't lending money to each other, then they're also not lending or renewing loans to businesses or people. Eventually, economic activity would come to a standstill. As we write this article, it now looks like banks are actually starting to lend to each other again.

The recent actions of the US government are without precedent. A conservative, Republican led government has bought equity in many financial institutions. Quadrant does not view the recent

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[1] Testimony before the US Senate Committee on Banking, Housing and Urban Affairs, September 23, 2008, Washington, DC

actions of the US government as handouts to Wall Street. We note that that the media was quick to label Warren Buffet's purchase of Goldman Sachs equity as an "investment" but when the US Treasury steps in, then the media calls it a "bailout." For example, with AIG, the US government is lending the insurance company up to $123 billion at a floating rate of interest of three-month LIBOR *plus* 8.5% or about 11.5% at current rates. On top of that, all the assets of the corporation have been pledged to secure the loan and the US government has a 79.9% ownership stake. These are tough terms for AIG and they create a very powerful incentive for the company to pay down the loan as soon as possible. AIG is still a going concern and the US Treasury action will permit it to realize more than fire-sale prices for the business units that will be sold to payoff the loan.

Peeking forward

With the size and speed of these events, we have all seen the newspaper headlines and television news constantly blast out the latest swings in stock market value and columnists and pundits comment on the latest developments. People are watching short-term market movements with the same intensity of the ninth inning of a World Series championship seventh game. This constant attention to capital markets has added fuel to the crisis and is promoting fear and panic.

Exhibit 6

3Q08 OEPS growth by sector

		Yr/Yr % Change in OEPS		
Sector	# Reported	Actual Growth *	Blended Growth **	% Points Exceeding Expectations
Energy	6	54.6	52.8	9.0
Consumer Disc.	23	47.3	-14.9	-0.5
Technology	29	19.3	8.4	6.8
Consumer Staples	15	10.7	9.5	2.5
Health Care	20	8.9	8.9	4.4
Utilities	0	0.0	0.0	0.0
Industrials	29	-1.3	1.2	1.3
Telecom	1	-5.6	-10.3	-5.6
Materials	10	-8.6	0.0	0.3
Financials	33	-115.4	-92.0	NM
S&P 500	**166**	**-19.6**	**-9.2**	**0.4**
S&P 500 ex. Financials	**133**	**12.0**	**12.6**	**3.3**
S&P 500 ex. FN & EN	**127**	**8.1**	**3.0**	**2.6**

Source: BBH Portfolio Strategy and Thomson Financial

What is expected to happen in this last quarter of the year and once the calendar starts saying 2009? In August, Quadrant reported that, aside from financial services companies, most other sectors of the US stock market were reporting growth in their second quarter operating earnings compared to the previous year. Is corporate America still moving forward? Yes. Earnings growth is continuing as companies are currently reporting their third quarter results. Again we are looking at Brown Brothers Harriman (BBH) reports on S&P 500 companies. BBH expects earnings per share from operations to grow about 12% when comparing third quarter 2008 results over third quarter 2007. Like last quarter, Energy is expected to be the leading sector with earnings growth of about 50% as the average price of a barrel of oil during the quarter was $120 USD. Looking forward, there is need for caution for the fourth quarter. The current outlook sees a slight operational earnings decline in the fourth quarter of this year of about 2% from the fourth quarter of 2007 as the US economy is slowing down. The first quarter of 2009 is anticipated to have flat operational earnings growth compared to the first quarter of this year. These are just estimates at this stage. Of course, we don't know how deep or how long these current market or economic conditions will continue, but recent declines in commodity prices, lower inflation and very significant cuts to US Fed Funds interest rates could very well increase first quarter 2009 operational earnings growth.

Quadrant's actions

Quadrant constantly examines what investment managers are doing and the type of stocks they are holding. We're talking with investment managers and analyzing their communications. Like Quadrant, they are bullish for the long-term. One of them writes, "We are putting extra time into balance sheet analysis and are targeting companies with low levels of debt and high levels of free cash flow. We want to own the companies that are best-positioned to survive and prosper through the current economic dislocation." Another investment manager we closely follow is having its analysts reassess portfolio holdings by stress testing the intrinsic value of companies under extremely pessimistic assumptions. This approach ensures their portfolios will be strong in today's markets and will be setup for future growth. They tell us that, "We have maintained our value discipline and long term approach by continuing to invest in relatively undervalued lower price-to-earnings stocks with better-than-market dividend yields in our portfolios."

Patience is paramount. When confidence is restored companies of good quality should benefit well. But in the interim, until the time when confidence is restored, Quadrant continues to work on your behalf. We can't control the world's capital markets, but are staying calm and taking action:

- We are communicating with you either in person or on the phone.
- Diversification between different asset classes and geographic areas, as outlined in your IPS, continues to make sense and helps withstand the downturns in the stock market.
- We are looking at every account and initiate tax loss selling where appropriate to offset previous capital gains taxes.
- And in this time of higher than average stock market movements, we have been examining rebalancing practices to ensure the process continues to be appropriate.

We will also continue to serve you and your investment needs with a globally diversified value-style portfolio designed to help you reach your long-term goals. As difficult as these days in the markets may be, we remind you yet again: investors will only be rewarded if they remain invested.

Please feel free to share your thoughts with us – we're always looking for ways to serve you better.

Sincerely,
Quadrant Asset Management

MP/MS/RI