



From: Heydon Traub
Traub Capital Management
97 Chapel Street-3rd Floor
Needham, MA 02492
Fax: 781-898-7647
Phone: (781) 453-3929
Cell: 781-405-4410

4TH QUARTER MARKET COMMENTARY AND OUTLOOK

Given that we have just experienced the worst week the Dow has ever seen, and that includes the Crashes of 1929 and 1987, I have put together some thoughts that will represent our normal quarterly outlook and commentary. However, since this quarterly report won't go out for as much as a few days and a lot can change in that time in this environment I am sending this out now.

In my last commentary which was only a bit over three weeks ago, I noted that the market had begun to look undervalued, but that the market could go down more given that it often overshoots as it moves from overvalued to undervalued and vice versa. I have to say that the same is true, but with one big exception: the market is now clearly undervalued in our view.

There are really two likely scenarios. One is that we are in a recession in which case we are likely very close to the bottom and may have seen the bottom this past Friday as the market bounced 7% off its low that day. The second scenario is that we are headed into something much worse, a depression, that would likely lead to another 50% decline or so from here. We expect the recession version to play out this time.

Looking at past recessions as a guide, the two worst recessions in terms of market declines occurred in 1973-1974 and 2000-2002, where we saw returns of -45% and -50%, respectively (from peak to trough). If we were to roughly match those in terms of severity, then we are done going down as the bottom on Friday was a decline of about 47%. We have had declines of 40% or more 10 times before this one, but none ever went higher than 50% except the fall during the Great Depression.

Many may feel that it's different this time since the housing market has collapsed and the credit market has seized up. But each time we have these large declines there are serious problems that don't seem like they will be resolved. It just seems worse when you are living through it partly because it is hard to see what will lead things to turn. But inevitably things do improve. And the market usually turns 3-6 month before the economy does. So if this recession is of typical length, it makes sense that the recession will end in the spring meaning we should be hitting the bottom in the next month or two.

Some experts say that we can't hit bottom until we see capitulation by most investors and that we are not there yet. Well last week we saw all the signs of capitulation. We had the worst percent decline ever for the week on record volume. We saw the Vix, a measure of fear as measured by the options market, not only break through its previous all-time high in the 50's, but shoot through the 60's and a peak at 77 this past Friday, about 70% higher than its highest level it hit during the time around September 11th. Legendary investor John Templeton was noted as saying buy at the point of maximum pessimism. I think we saw that on Friday.

Jeremy Grantham, a well-known manager at Grantham Mayo has been a bear for at least the last decade. He was quoted recently as saying he thought fair value for the S&P 500 was 1025, suggesting that the market is now 14% undervalued. In that same interview that ran in Barron's over the weekend he noted that markets usually overshoot and he expected the market to fall to 820 on the S&P, just 20 points below where it

bottomed on Friday. This would be a 10% decline from Friday's close. For anyone other than a short-term investor, buying now and facing another 10% decline is no big deal. When markets bottom, the recovery can often be sharp and quick. At the last big market bottom there was a 50% gain in less than 15 months. Even if you had bought before the final 10% decline, you still had a 35% return in less than a year and a half.

There are other reasons the market may be overshooting here. Many investors received their quarterly statements last week and seeing big declines in September and knowing they had even bigger ones already in October, there were likely many that threw in the towel and sold. Also, there was forced selling over the last month. Highly leveraged hedge funds would be forced to sell to maintain leverage below a certain level. Similarly, investors who bought on margin were likely sold out automatically by their brokers. There were notable insiders at Chesapeake Energy, Coca-Cola Enterprises and General Growth Properties who had bought large amounts of their company's stock on margin and were forced to sell last week.

Other reasons for overshooting were represented by comments from some fund managers who have sold in anticipation of withdrawals from investors. Waddell and Reed has claimed that they have raised cash levels across their funds to an incredibly high 22-23%. When the markets start going the other way, they will feel pressure to get back into the market quickly.

There are a couple of other factors showing the market is oversold and ready to move up. There are a record percentage of companies trading at market values below the cash on their balance sheet. Closed-end funds are trading at record discounts with some at prices more than 50% below the value of their assets.

The market is now trading at a forward p/e of less than 11 and less than 9 times estimates for 2009. Now most would agree that those estimates are too high, thus understating the level of the p/e. The earnings represent an aggregation of each company's estimated earnings. At turning points in the economy like we are in now, the better measure of earnings estimates are from analysts who estimate the earnings "top-down", i.e. not company by company but forecasting the aggregate of earnings. These are 16% lower for 2009. But if these are more realistic, the market is still trading at a very reasonable p/e of 10.

One last piece of analysis as it relates to the worst case scenario, where we do have a depression. During the Great Depression the market fell 89%. Thanks to the laws of compounding this doesn't mean we fall 46% from here (having fallen 43% already), but would suggest a fall of 80%. We think it's VERY unrealistic that would occur. The U.S. market 80 years ago was essentially an emerging market with few safeguards built in. There was almost no government intervention early on, no Federal Reserve cutting rates, and no deposit insurance. No deposit insurance was a huge problem as there were huge runs on banks taking capital away from banks as people put it under their mattresses. Since banks lend multiples of their deposits this was a huge drag on the availability of capital, something we are seeing now but to a much lesser extent thanks to deposit insurance. In addition, the market was at much higher valuations back in 1929 having run up nearly 500% from 1921 to 1929. The gain this time from 2002 was just 94% and we began this with p/e's of the market in the high teens, only a bit higher than normal, not the record levels that existed in 1929 and in 2000.

In sum, nobody can time the exact bottom, but the risk/reward has swung to a pretty favorable time to own stocks in our view. You may lose 10% or more before we hit bottom, but if you are a long-term investor who plans to hold at least 3-5 years you are likely to earn very solid returns over that timeframe.