CORE Comments
ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

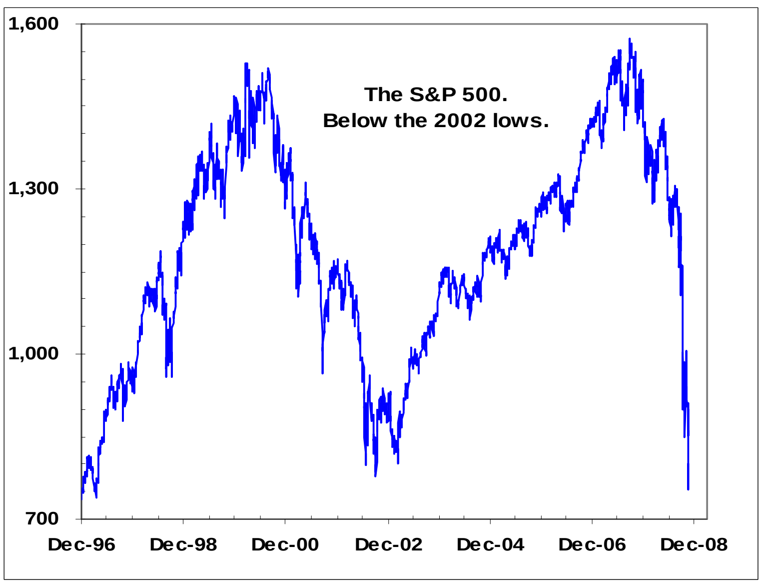
November 23, 2008

How We Will Make Money

Paulson's announcement that TARP funds will not be used to buy mortgage-backed securities put fear and uncertainty back into markets. Citigroup and the US auto markets are tottering. The stock market fell below its 2002 lows.

When I last wrote a couple of weeks ago, I reported that conditions in the credit markets were improving. This suggested that the concerted actions by our fiscal (the Treasury) and monetary (the Fed) authorities and by their European and Japanese counterparts were working. Since then, Treasury Secretary Henry Paulson declared that the Treasury would not use the $700 billion in TARP funds to buy subprime mortgage-backed securities from banks. The already-announced direct federal investments in banks were a better use of the $700 billion, he informs us. Although it had been well known that the Treasury had shifted the approach, his declaration of the change appeared to have been the signal for the markets to attack banks that held large amounts of these toxic securities. Improvement in credit markets came to a sudden end; bank stocks fell anew; and the stock market again shuddered and fell.

Meanwhile, the flow of economic reports suggests that we are well into a severe recession. Retail sales dropped dramatically in October; the ranks of the unemployed are rising at three times the level of the first half of the year. No one can know how deep the recession will be, how long it will last, nor how broadly around the world it will spread. Recessions in Europe and Japan have already officially been announced. America is certainly in a recession, but the organization that declares the starting and ending dates has not yet spoken.



On Thursday of last week, the stock market fell in its final hour, and the S&P 500 fell below the lowest level of the 2000 to 2002 bear market. The nearby chart shows the picture. It is certainly possible that the market will fall further: there may well be further significant write-downs by the banks. Once mighty Citigroup lost more than half its value last week; this weekend may produce yet another bailout by the Treasury and the Fed to keep Citi from going under. The US car companies pleaded in Congress for their own bailout, citing the possibility of enormous losses of jobs if one or more should be forced into bankruptcy. But Congress adjourned without taking action and Paulson declared that the $700 billion in TARP funds would not be used for the auto industry. And so, there is real risk that, despite a fifty percent decline in the S&P 500 in the thirteen months since its high, we may sell more selling in stocks. Similarly, despite declines in housing prices, lower housing prices lie ahead. Essentially every asset on the planet has declined sharply in price in recent months, excepting the US dollar, US treasury securities, the Japanese yen, and Japanese government bonds.

By

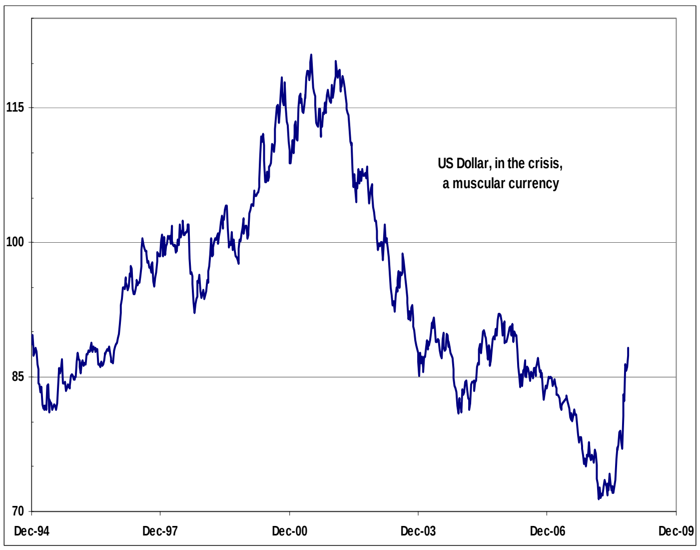
Jack Mayberry

Without further reporting of the news of the last two weeks, I write of our investment plans, touching on the two primary issues: first, how will we mitigate losses in the your portfolios in the still-difficult markets, and second, how will we earn back for you the losses incurred in recent months.

Managing risk. As you know well, we have large cash reserves in your accounts. Although we have lost money this year, despite sizable cash reserves, our losses have been far less than those of the markets. Because further losses for most investment assets probably lie ahead, we will hang on to cash until we have more assurance that the worst has passed. Recently, we have made some changes to portfolios. We have sold outright some positions against the risk of further declines. We have also sold certain positions and replaced them with deeply-discounted closed-end funds of the kinds we have discussed in recent letters. In doing this, we have replaced riskier investments with safer ones. And the safer ones--the closed-end funds--have the added advantage of selling at discounts. We are exploring investments that will do relatively well in recessionary environments and will discuss these as we make them. Because selling has been so indiscriminate since September, many assets with real value, including those that do well in recessionary and/or deflationary environments--high-grade corporate bonds, for example--are on offer at exceptionally low prices. Thus, we are being given the opportunity to manage risk and to make money.

The US dollar and the Japanese yen and the government bonds of those countries are essentially the only assets that have not fallen precipitously since late summer.

Earning money when the bear market ends. The recession may be a deep one and it may last for a long time. But it is certain that before the recession ends, this bear market will have ended and the new bull market will be well underway. We have begun making investments in closed-end funds that we expect to provide very significant gains when we recover. As we have written recently, we will earn investment returns in two ways with these funds: We are buying them at very large discounts to the values of their underlying portfolios. When stable conditions return and panic selling ends, these discounts will narrow. As stocks recover from this fantastic bear market, as surely they will, the values of the underlying portfolios will rise with the rest of the market.



To explain this in concrete (but hypothetical) terms, consider the Eaton Vance Tax-Advantaged Global Dividend Income Fund, symbol ETG, which we own. ETG holds a diversified portfolio of large, financially strong companies, US and foreign. Astonishingly enough, at the close on Friday, ETG traded at $8.06 per share, but the value of its portfolio was $11.80 per share. This discount--more than 31%--is far higher than its typical discount of 5% or so. Assume for the sake of argument that the bear market ended on Friday and that the recovery begins from here. ETG's underlying portfolio will recover roughly in line with the stock market, say by about 40% within the a year or so. Thus, the portfolio would be worth $16 per share. Meanwhile, panic will have subsided and the discount will shrink to 10% or so, bringing the share price, in this example, to $14.40, from its current level of $8--a gain of about 80% from Friday's close.

We held ETG for a couple of years when the bull market was running and enjoyed good gains from the investment. We recently reviewed its returns since its 2004 launch. From 2004 until the bull market highs in the autumn last year, ETG outperformed the S&P by a very large margin. Our example in the preceding paragraph assumes that ETG merely matches the return of the S&P. It may do better, as it did from 2004 to 2007. It has underperformed the S&P since last year, because its discount has widened from 8% to 31%, typical, though extreme, bear market behavior for a closed-end fund.

Each year Core Asset Management files with the SEC a form ADV with information about our company. If you would like a copy of Part II of Form ADV, please contact us.

Core held large investments in REITs (Real Estate Investment Trusts) for a few years after 2002. We sold these after their prices had risen to levels never before seen in REIT-land. Prices went higher still after we sold our positions, but now they have come back to earth with a thud. A well-regarded REIT ETF run by Cohen & Steers traded above 110 in early 2007. On Friday, this fund, symbol ICF, traded below 27; its dividend yield is now 11.4%. We are not rushing out to buy this on Monday, but we have it in our sights. We anticipate making REIT investments again, now that they are giving them away.

The list of wonderfully cheap investments is already enormous. It will probably grow further, if and as the bear market continues. We will be alert to the signs of the bear market's end. We will hold our cash reserves--we may invest some cash in bonds--until we become confident that the bear market is over. At that time, we intend to invest aggressively in some of the exceptional investment opportunities that lie before us. As dreadful as this bear market has been, our fortunes will improve.

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CORE ASSET MANAGEMENT
PO Box 1629
108 Caledonia Street
Sausalito, California 94966
(415) 332-2000 • (800) 451-2240
fax (415) 332-2151
www.coreasset.com
info@coreasset.com