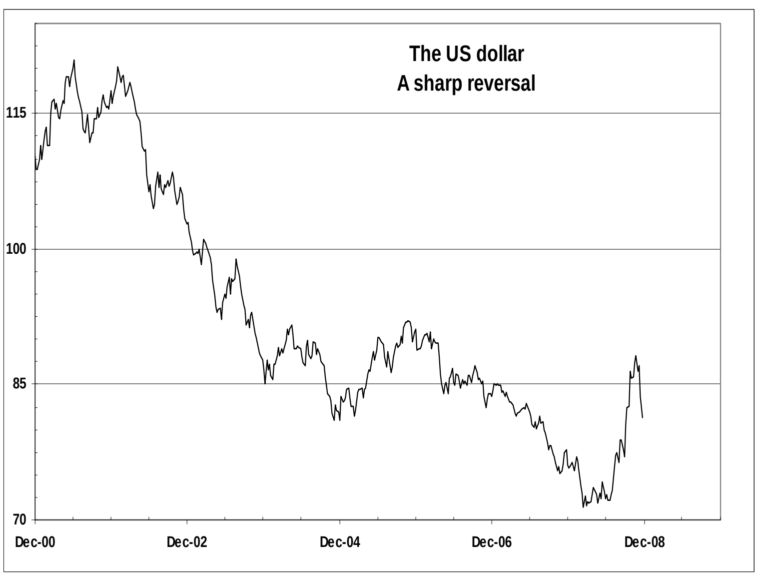
CORE Comments
ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

December 23, 2008

## Toward Another Year

*After a strong US dollar rally for several months, currency markets have begun to swing and the dollar has declined. Stock markets have been trading more quietly, and interest rates on Treasury securities have fallen to record lows.*

It is fitting that this year filled with terrible news for the economy, the housing market, the banking system, and the financial markets should reveal, at its close, a scandal of exceptional proportion. More than fitting, it may be found that the Madoff fraud was revealed at the end of this year precisely because of market and economic conditions: The recent months of losses in almost all investment assets have been driven, in part, by forced selling of many funds and financial institutions. Selling was necessary because of impossibility of maintaining huge levels of debt as asset prices fell. According to the criminal complaint against him, Madoff told his sons "that he had for years been paying returns to certain investors out of principal received from other, different, investors." In the environment of forced selling, investors in Madoff funds were seeking redemptions at a rate faster than new investor funds could be found.




We know little from the authorities about all this except for the five-page criminal complaint and the remarkable statement by SEC Chairman Christopher Cox, acknowledging that credible and specific complaints about Madoff's operation were given to the SEC beginning in 1999, complaints ignored by the SEC. We will know the full story in time. We will learn how so many individuals and institutions fell victim to Madoff and why regulators turned a blind eye to him and his firm. We will learn whether some of the many banks and investment firms that directed money to Madoff were knowing participants in the fraud from which they profited. More to come.

**The Federal Reserve's** Open Market Committee met last week and lowered Fed funds, the short-term rate it directly controls, to a range of 0% to 0.25%. No further cuts there. But the Fed's announcement discussed other actions it is taking and will take in its attempt to get credit markets functioning, to revive economic activity, and to prevent deflation. These include its recent lending as the only functioning bank in the country, direct purchases of long-term treasury bonds and mortgaged-backed securities held by Fannie and Freddie, and the possible purchase of corporate bonds. On Friday, the Fed announced that hedge funds will be able to borrow up to three years to fund purchases of securitized consumer loans. This is a truly remarkable announcement, indicating the depth of the failures in the markets for non-mortgage securities. The consumer loan securities in this Fed program (with

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the infelicitous name Term Asset-back Securities Loan Facility, or 'TALF') include credit card receivables and automobile loans.

*We have purchased bonds of financially strong US companies. Separately from this, we are doing some tax-related selling in various accounts.*

The Fed's announcements and actions show its determination to act in this crisis; they also show the severity of the problems. One result has been the precipitous decline in yields in treasury securities. Three-month treasury bills are trading for essentially no interest and the ten-year bond yields 2.17%.

**Our investments.** Because of these conditions in the market for treasury securities, there are exceptional opportunities in other areas of the bond market. We wrote last time about our interest in high-grade US bonds. We made another purchase last week, buying an exchange-traded fund that holds corporate bonds issued by large, financially strong US companies. As discussed in the last letter, in normal environments, such bonds yield only a bit more than treasury bonds, but in this year of remarkable dislocations, the spread between treasury yields and those of the best companies has widened to unheard-of levels. Although treasury yields have fallen to exceptionally low yields, corporate bonds yields have remained rather high. When economic and financial conditions return to normal, as they will in time, the spreads will narrow and the prices of the bonds we own will rise. In the meantime, we will collect an attractive and safe yield of more than 5 percent.

In the last few weeks, the stock market has taken a respite from its extraordinary volatility and vicious selling. Daily swings have moderated; we have seen fewer of the four percent daily gains and losses, and prices have moved well above the panic levels of November 21. But as the stock market has begun to look somewhat more sober, currency markets have lunged and staggered about like drunkards. As the Fed has moved aggressively to lower interest rates and expand its balance sheet--to run the printing press at full speed--so the fears have grown that its action will cause inflation and weaken the dollar. Thus, after a four-month, 22 percent appreciation in the value of dollar against the currencies of its major trading partners, the dollar has fallen by 8 percent in four weeks. Hold on to your hats.

**Tax-related trading.** In taxable accounts, we are selling some positions with unrealized losses and replacing them with similar investment positions. We would far rather have gains to show, but this is 2008. By selling positions and realizing losses now, we will be able to offset future capital gains and derive some benefit from this nasty year. This activity does not materially change the investment profile of your accounts.

*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.*

**This year and next.** This has been a year of exceptional challenge for investors; it is unlikely that 2009 will present a smooth glide. We have our work before us. I intend to write a fuller picture of the events of the year as these bear on what we do to protect your capital and to earn money in this new world.

For now, let me close by expressing my gratitude for the opportunity to work with you and to work for you. I have remarked in the past that investing offers me a wonderful intellectual challenge; in recent months, the intellectual challenge on offer has gone rather far beyond the merely wonderful. We have losses this year, losses we all regret. But we also have ample cash reserves ready to be put to work in this new era. We have investment plans now. We refine and reconsider them continually. Please accept our thanks for giving us the privilege to pursue to pursue this work for you. Let us look to the holidays and to the prospects for a year of recovery and renewal in the lives of all of us on this planet.

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