KEATING INVESTMENT COUNSELORS, INC.
REGISTERED INVESTMENT ADVISORS FOR INDIVIDUALS, RETIREMENT PLANS, TRUSTS AND FOUNDATIONS

Investment Strategy
October 2008

A September to Remember…

September 2008 will be long remembered as a watershed moment in which the course of financial market history changed dramatically. With so many stunning and significant events occurring in such a short time, many people feel compelled to do something, anything, to react to what is happening around them. However, in the words of John Bogle, founder and former CEO of the Vanguard Group, "Time is your friend; impulse is your enemy." With that in mind, now is a good time to reflect upon recent events. First, was the September 7 government takeover of Fannie Mae and Freddie Mac. Eight days later on September 15 we awoke to news of the bankruptcy filing of Lehman Brothers and the announced acquisition of Merrill Lynch by Bank of America. Two days later, on September 17, the government intervened to save American International Group from imminent failure. Just a week after AIG, we witnessed the largest bank failure in U.S. history with the government takeover of Washington Mutual. Finally, on September 29, we saw the government's proposed sale of Wachovia's banking assets to Citigroup that required government assistance to complete.

This chain of events resulted from a lack of trust in the capital markets. With major investors unwilling to participate in the markets and banks unwilling to lend to each other, distressed companies were left with few options. In the case of Fannie Mae and Freddie Mac, the two mortgage institutions were no longer able to raise fresh capital through private investors after predatory trading drove down their share prices. Fear of their failure spread to the international markets, causing demand for their agency bonds to decline substantially. This resulted in higher mortgage rates at the very time lower rates were needed to support a weak housing market. The government, under direct pressure from foreign holders of Fannie Mae and Freddie Mac debt securities, stepped in before the problem spiraled further out of control.

With the same predatory pressure driving down Lehman Brothers' stock, this investment bank was also pushed beyond where it could raise sufficient capital to offset increasing losses from its securitized debt holdings. Despite government arranged meetings to find a private sector solution, the firm was allowed to fail. The government sent the message that not all distressed companies would be offered help, further eroding confidence in the markets. During this same weekend of negotiations regarding Lehman, John Thain, CEO of Merrill Lynch, realized it was only a matter of time before his company suffered the same fate. Within 48 hours, Thain arranged a pre-emptive sale of Merrill Lynch to Bank of America.

The government's inaction on Lehman froze world credit markets as institutions tried to sort out the damage from the bankruptcy filing. The general public first felt the bankruptcy impact when several money market funds that held Lehman commercial paper were forced to "break-the-buck" by reporting asset values under $1.00. Commercial paper markets, essentially the credit cards of corporate America, funding everything from inventory to payroll, also stopped functioning as creditors were in fear of holding paper from the next Lehman. Credit default swaps, a derivative

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that provides insurance against bond losses, saw prices skyrocket on this same fear. To support their open positions the sellers of these credit derivatives were forced to find $140 billion dollars in new capital on September 15 alone. American International Group (AIG), which had an AAA credit rating earlier this year, was one of the biggest players in the credit default swap market and was already struggling with $14 billion in additional capital requirements as the result of a ratings downgrade. Losses in these credit default derivatives quickly sent AIG over the edge. AIG's demise was followed quickly by the decision of both Goldman Sachs and Morgan Stanley to convert into bank holding companies, bringing both greater government protection and regulation. With no remaining major independent investment banks, this marks the end of an era on Wall Street.

The problems on Wall Street and the constant barrage of fear did not go unnoticed on Main Street. News outlets were on watch for the next big failure and began to focus their attention on Washington Mutual. This focus resulted in depositors making significant withdrawals in search of greater safety. The Office of Thrift Supervision and the FDIC were paying close attention and, with fear enveloping the market, moved quickly to take over Washington Mutual before the damage was beyond repair. Washington Mutual's assets were quickly sold to JP Morgan and no depositors suffered any losses. The media now focused on Wachovia. Under mounting pressure, with government assistance, arrangements were made to sell Wachovia's banking assets to Citigroup. However, in what may be a very good sign, Wells Fargo decided to make a higher offer for Wachovia, without using any government assistance. Assets may finally be so cheap that companies are starting to bid higher for ownership.

All of these actions did little to solve the underlying problem afflicting the markets: declining house prices causing mortgage losses for financial institutions. As banks became more concerned about each other and their own stability, hoarding cash became paramount, causing lending markets to stop functioning. The root cause of the problem is the inability to value complex mortgage assets that banks own, making it impossible to estimate future losses. In an attempt to restore order, the government took the unprecedented step of passing the $850 billion Troubled Asset Relief Program (TARP). Under the program, the Treasury Department is authorized to purchase mortgage related securities from various financial institutions and hold the securities until orderly sales can be completed. This plan should help clear these un-priced securities from the banks and bring clarity to their balance sheets. The hope is that with these questionable assets removed, institutions will be willing to lend and more normal credit market conditions will return. As normalcy gradually returns to the market, it is expected the government will eventually be able to sell these assets for reasonable prices, possibly even resulting in a profit.

Not since World War II have we seen the financial landscape in the world change so dramatically. Market regulation will be completely overhauled over the next few years which should provide greater stability and transparency to the market. The national savings rate should rise substantially to make up for the past several years in which people used their rising home values as both their personal ATM and in place of retirement savings. The end of the independent

investment banking era will force the remaining companies to be managed much more conservatively, resulting in not only less profit for Wall Street, but much less volatility and risk for the financial marketplace as a whole. The trends that have tilted the market in favor of the extreme leverage used by private equity, hedge funds, and Wall Street investment bankers over the past decade will reverse.

…Will It Be Over In October?

These are clearly difficult times, but we remind clients that we have been through many extremely difficult times in the past thirty-five years, most often climaxing in October. After past periods of extreme market volatility like October 1974, October 1987, October 1990, October 1998 and October 2002, quality prevails. In recent days it is evident that hedge funds and other leveraged participants are being forced to sell their commodity and stock positions at any price. Even worse, they are shorting some large, high quality companies as a hedge against their lower quality declining positions that they are unable to sell or short. In line with the previous October examples mentioned above, this forced liquidation will likely result in a panic climax in the stock market – "the baby gets thrown out with the bath water." This has typically been followed by a rapid price recovery for the best companies.

In periods of lowered growth expectations and increasing stress, money ultimately flows to the large leadership companies with strong balance sheets, dominant market positions and brands, and long dividend histories. Our investment strategy is consistent in good times and in bad: investing in leading companies with strong managements that have succeeded over the long run and that we have reason to believe will continue to succeed. Our strategy has proven to be less volatile than the market, particularly due to the return of cash to investors through dividends. A new Standard & Poor's study shows that, in the twelve months through September, dividend-paying stocks outperformed non-dividend-paying stocks by 5.4 percentage points. Our managed portfolios were generally in line with this experience.

Given the magnitude of recent events, we are cautious and deliberate in our approach. The economy and markets still face difficulties. However, we are also mindful that these factors may already be priced into the markets, setting the stage for a sudden and strong rally. As Warren Buffett, the world's richest investor, once said, "Be fearful when others are greedy, and be greedy when others are fearful." In a very encouraging sign, Mr. Buffett has begun deploying his large accumulation of cash. In two weeks in late September he bought control of a large nuclear power producer, Constellation Energy, and invested billions more in Goldman Sachs and General Electric. With much of the world now fearful and the markets shrouded in uncertainty, we continue working to find the best values that will perform over time regardless of the current volatile environment. As always, we keep our eyes focused on the longer term horizon of our client's continuing needs and remain confident that our patient approach will prove successful.

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Keating Investment Counselors, Inc.