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ValueWorks

quality assets. compelling valuations.

MARKET BULLETIN **September 15, 2008**

Navigating Market Turmoil . . .

The current storm in the financial markets clearly represents a historically large challenge for investors. But it is also the type of turmoil that investors have been called upon to navigate several times over the past two decades. Experience shows that while these periods can offer near-term downside to all investors, and significant ultimate risk to poorly constructed portfolios, they can also offer significant opportunity to those that prudently and properly navigate the turmoil.

While we have been tepid buyers of select financial companies through this cycle, we have been cognizant of the risks and have consequently limited our exposure to this industry. On the one hand, we expected a more responsible and effective policy response by regulators and the government, and therefore we put money to work in this space – admittedly in some controversial names – in anticipation of a powerful rebound. On the other hand, we recognized the risk of poor policy responses, and so have limited our exposure both to only a few names and to a modest percentage of the overall portfolio.

By design, many of the companies in our portfolio represent a diversification from financials and will be largely insulated from the problems in that industry. Our most recent purchase, Teco Energy, operates an electric utility and coal mining operation. Modest growth in their service territory is already priced into expectations. They should see little business disruption from the financial debacle, and the share price should remain supported by a decent yield. As confidence returns to the market a recognition of the value of their coal mining operation could result in a 50-100% appreciation in the share price.

Further, both 3M Co. and Dow Chemical could see significantly improved results as lower commodity costs bolster their profitability. Both companies trade at strikingly low valuations even without that benefit. Similarly, it is hard to see how this crisis would negatively impact Boeing. Their defense business is not subject to economic gyrations, and their commercial aircraft business has many more orders for planes than the company can fill for the next several years. As a result, even if global economies slow and customers push-back delivery dates, there will be minimal impact on Boeing's results. Moreover, each of these companies do not need access to the financial markets, but rather all three have been generating excess cash flow and buying back shares.

Similarly, the pharmaceutical and medical products exposure in our portfolios (Schering Plough, Pfizer and Boston Scientific), may demonstrate volatile share prices. But their business operations should not be impaired by either the turmoil in the financial markets or an economic slowdown. These companies are not cyclical, do not need financing and are generally throwing off significant free cash flow, paying big dividends, and buying back shares.

We also consider our energy company exposure to be well positioned. We have focused on natural gas oriented companies. While the share prices are down from recent highs as crude oil and natural gas prices declined, the companies used recent high natural gas prices to their advantage. Not only did they hedge future production at high prices, locking in significant earnings streams for several years, but they took in joint ventures partners to fund expansion.

The other names in our portfolio represent further diversification and are in our view particularly attractively priced – generally offering good downside protection and compelling upside potential.

Even among financials, we have significant exposure to companies that do not rely on financial leverage. Legg Mason is impacted primarily through its money market funds, but that issue is contained and resolved. Ambac and MBIA, two monoline bond insurers, may or may not pay significant claims on defaulting bond obligations -- but they do not need access to the capital markets to run their operations. At this point we are making money in both of those investments – and would indeed scale them back as conditions warrant.

Our exposure has been in Freddie Mac, Washington Mutual and Wachovia. At this point, only Wachovia represents any further economic risk to the portfolio.

ValueWorks' Top 10 holdings:

1. **Cypress Semiconductor**
2. **Chesapeake Energy**
3. **Mbia Inc**
4. **Rowan Companies Inc**
5. **Boston Scientific Group**
6. **Dow Chemical Company**
7. **Mcgraw Hill Company**
8. **3M Company**
9. **Legg Mason Inc**
10. **Walt Disney Co**

—as of 08/31/08—

Speaking to the question of which financial company is next to succumb, Washington Mutual is already priced as if it has failed. Can Wachovia be next? Of course, if these conditions continue, the entire financial services sector will be shuttered. We expect a better policy response before that happens, but will remain very cautious in our exposure – despite nearly unprecedented valuations – until we see some of the damage repaired.

Given current levels, we plan on holding both Freddie Mac and Washington Mutual. In the case of Freddie Mac we could see upside to the double digits if current policies are reversed. We see similar upside if Washington Mutual is able to see itself through this storm. In both cases, our investment at current levels is negligible relative to both the potential upside and the overall value of the portfolio.

In summary, while our portfolios have seen declines generally in line with the major indexes, they should prove well positioned to weather further volatility. Our further exposure to the credit crisis is modest. The remaining exposure in the portfolio is well diversified in generally large, stable, well financed and attractively priced issues that should offer very compelling upside as conditions stabilize.

—Charles Lemonides, CFA

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