April 2, 2008

Client
Address
City

Dear Client;

The first quarter provided a rougher ride in the markets than what I expected, as I underestimated the impact of contagion and leverage on the global credit markets that were initially disrupted by defaults on sub prime mortgages. The result was widespread liquidation of assets and a resulting broad price decline in most asset classes.

Let me touch first on the contagion aspect of the financial system's problems. Credit markets (for bonds and loans) continued in disarray as lenders having been burned by previous questionable sub prime mortgage loans refused to invest in anything other than the ultimate safety of direct government securities. This had the effect of turning previously liquid and efficient debt markets for corporate, auto, credit card, student and prime mortgage loans into unreliable auctions that at times lacked any buyers at all, even at fire sale prices.

That highlighted the issue that many loans are held by leveraged institutions (those employing borrowed funds) such as banks, brokerage firms, hedge funds and insurance companies. These investors may borrow 10 to 30 times the face amount of loans held to enhance returns. This is known as spread lending, borrowing at a lower rate and investing at a higher rate with the goal of earning the difference, or the spread. However, when employing 20 to 1 leverage, a 5% decline in the value of loans held wipes out the holder's equity, leading to a failure of the business.

So price declines in loans caused a panic with leveraged institutions looking askew at one another while pulling back funding and focusing on self-preservation. However what works in isolation does not work in a networked situation like our financial system. As funding was withheld, failure ensued in the form of hedge fund blowups, mortgage lender bankruptcies and a Federal Reserve rescue of the nation's fifth largest brokerage firm, Bear Stearns. The Fed appears to have put a stop to the panic in March with a program to lend against many new types of loan collateral to both banks and primary broker dealers. Of course it took a major failure to inspire this new program, but at the end of the day the Fed stepped up as the lender of last resort, the job the Fed was originally designed to do.

These market disruptions had their start in the real economy, easy (stupid) lending standards for real estate. Thus a tightening of those standards has had and will continue to have a dampening effect on economic activity. This is a well-noted fact and so is already priced into many or all of the subject companies. As previously stated, my portfolios were well positioned going into this volatile period, with quality stocks, government bonds and not much consumer discretionary exposure. I did have a bit too much bank exposure in hindsight but had pared back to the best in breed. Had I read the future more successfully at year end 2007 I would not be positioned any differently now, but would have waited to deploy some capital from year end 2007 until the lows in January, February and March on this year.

Going forward government bonds and money market funds offer nothing in terms of return. The 2% expected return does not match the inflation rate even before taxes. Therefore I have been buying a muni bond fund, a corporate loan fund and adding to quality stocks. I need to continue to increase exposure to risky assets now that prices are cheap, but not too fast as it is still an uncertain environment. I have been soaking up cash not currently being used with bank certificates of deposit at 3.5% as money market returns are headed under 2%.

The problems in real estate and finance could lead to an extended below trend period for the economy so it is prudent to go slow in adding to economically sensitive companies. I think the commodity price run up and the weak dollar are way over done so while I would have liked to be in for the ride, I don't want to get in now for what could be a pretty big fall. It is hard to reconcile the deep concern of a soft economy priced into some stocks with a continuation of the commodity surge, so I'll just look for investments elsewhere.

Attached please find your portfolio report covering through the first quarter of 2008. While on a relative basis we did well and I am pleased with the principle preservation that demonstrates, the number still starts with a negative sign and that I am not happy about. As I have previously stated, opportunity and positive performance can be opposites. I am taking advantage of opportunities during this weak period in hopes of better returns going forward.

Best regards,

Peter V. Hedberg