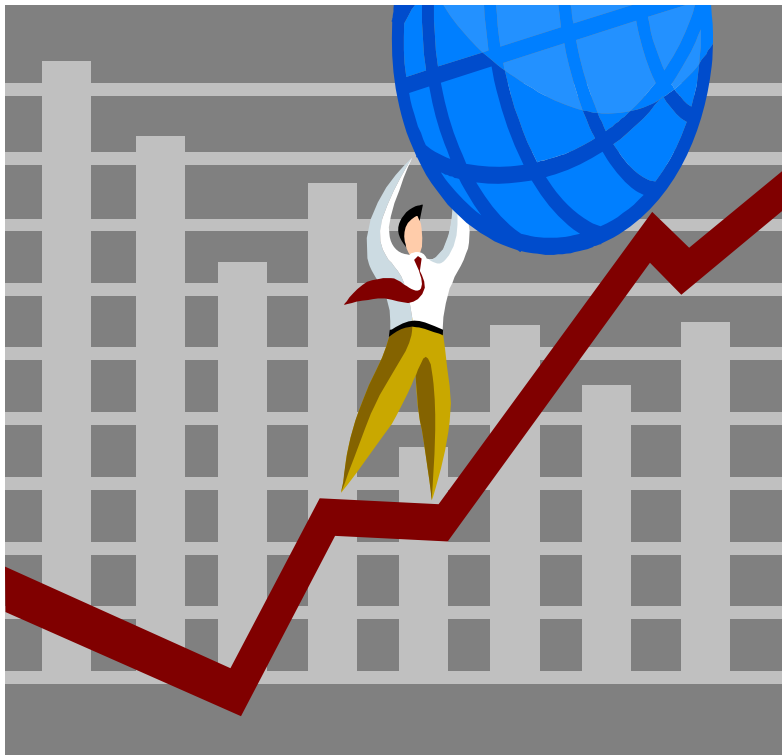


Gates of Hell

2008 Q1 Quarterly Commentary



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Gates of Hell

There are times in our lives when certain “dark” doors open up. We experience them sometimes privately as an individual, other times collectively as a people. When the doors open briefly, we see visions of chaos and of pain, and we are afraid. Poetically speaking, if the doors shut again quickly, only a bit of the foul ether comes through the doorway. But if the doors stay open, then hell becomes reality. This is the dark side of the human experience, and as adults we know there really is no way to completely avoid it. Many times there is no harbinger to these doors or gates opening. They just simply appear, like the perfect storm.

Thirty years ago when I was a freshman rowing crew at Columbia, the Junior Varsity boat (comprised of sophomores, juniors and seniors – those old guys) went out for an early morning practice. It was a cold, dark and blustery February morning. At Columbia, crews practice up at the northern tip of Manhattan. Our boathouse was on a stretch of the Harlem River called Spuyten Duyvil, which we translated as “spitting Devil”, but others have translated as “Devil’s spout”. Pick your definition; both accurately describe the incessant turbulent churning of the water there, which is caused by its physical location: the entrance/exit of the Harlem River with the Hudson River. In addition, the Harlem River isn’t so much a river as it is an estuary, a place where the Hudson River’s current meets the tides of the Atlantic Ocean in a very compact, narrow area.

This particular morning, the coach was having difficulty getting the engine on the tender to turn over. As the eight oarsmen and coxswain were getting pretty darn cold, the coach asked the coxswain to take the shell (the boat) out down the river, so that they could all warm up.

What no one knew was that at this precise time a large freighter was cruising down the Hudson River, yielding a uniquely large wake. The JV boat proceeded out into Spuyten Duyvil. Immediately the boat began quickly picking up speed as the ocean tide was receding fast. I always loved rowing down the Harlem in times like this as the boat could have a “land speed” of nearly 20 mph – you were flying!

Anyway, for the JV team, they already had one failure, the tender wasn’t operational. Secondly, the tides were wicked fast. Thirdly, and this they didn’t know, was that a huge wave caused by the freighter’s wake (a freighter they never saw) was coming straight for them. The wake entered the Harlem River and was fast approaching them, seemingly “running” on top of the already fast tide.

Had there been some harbinger, the coxswain could’ve maneuvered the boat to take the wave. But no notice was given. The boat was swamped instantly. Being a wooden boat and with long oars attached, the boat didn’t sink to the bottom, it just sank about two feet down. But with the river’s water temperature being 38 degrees, staying in the boat until the tender arrived wasn’t an option.

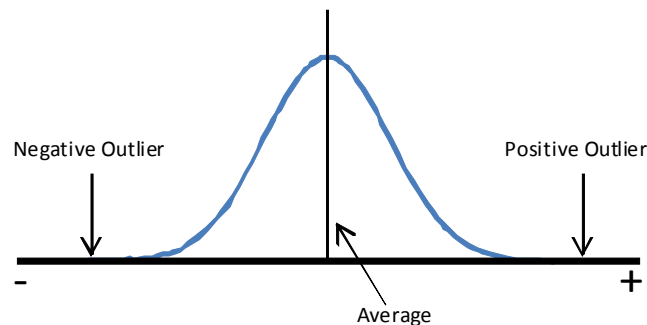
The captain yelled “Abandon ship!” – probably two words he didn’t think he’d ever say.

Oarsmen are actually tied into the boat (their shoes are part of the boat). So quickly, each oarsman untied or tore their feet from their shoes and began bravely trying to make it to The Bronx shoreline. Fast tides try to hold you to the middle of a river, so the oarsmen struggled to get to shore. When they finally made it, the team was scattered over a mile of shoreline.

On that morning seven oarsmen and the coxswain safely made it to shore. One oarsman was lost. It was thought that he had had a heart attack: brutally cold water like that can overwhelm the body. As is typical with winter drownings, his body was not recovered until mid-Spring when it resurfaced.

The gates of Hell opened up for this boat, this crew. What was supposed to be just another workout became a day that saw a man die and the lives of the rest of the crew marked forever. That's how it works. So fast, so complete.

Financial statisticians have a concept similar to these gates: they're called "outliers", and they subject portfolios to something called "tail risk" – the tail being the "very unlikely to occur" edges of a normal distribution. And like angels and demons, outliers and tails come in both flavors. The graph below shows both a negative outlier and a positive outlier on a normal distribution.



As nearly all successful investors are quantitatively based (either explicitly or implicitly), we try to use methods and models that work effectively within most of the time, if not nearly all the time. What we fear, and I do mean fear, is the negative outlier – some confluence of events that causes the financial system to lurch.

Q1 2008

It was historic.

The quarter saw an inter-meeting Fed cut, a foreign bank unwind fifty billion dollars worth of securities due to a rogue trader and the extraordinary bailout of an investment bank: Bear Stearns.

As we forecast in our [2008 Outlook & Strategy](#), "If investor fear can be abated in the first quarter, 2008 may be a real bounce-back year. But if investor fear can't be broken, we will experience intermediate-term volatility." Fear, as measured by interbank lending, wasn't broken in the first quarter and is now only slightly improving after historic intervention by the Fed.

Our intention in the first quarter (which we shared with you in last quarter's commentary) was to unwind our tactical overweight position in the S&P 500 (given its strong outperformance over the prior year and a half) and move back to our long-term equity strategic asset allocation, i.e. increase our exposure to small cap and value equities. We did complete this rotation effectively in January but decided by early March to temporarily take those same assets off the table.

In the end, what shows up numerically in this quarter's report is a modestly down quarter with commodities working especially well to reduce overall portfolio volatility. But what the report doesn't show is what we believe to be our greatest contribution this quarter, protecting our clients' portfolios against two massively negative events, or negative outliers, by reducing our equity position just days before each event.

First, with significant market weakness and overwhelming negative sentiment in the first couple weeks of the year, we decided to reduce our overall weighting in equities on January 17th and 18th. As you may recall, on the following Monday (Martin Luther King Holiday), and the following Tuesday morning, global markets sold off aggressively. How aggressively? In just a little over 24 hours the FTSE (London's S&P 500 equivalent) was down nearly 10%. Due to our recently lowered equity stake, our clients had less at risk. When the US markets opened up on Tuesday, the Fed had just reduced the Fed Funds rate by 75 basis points in an historic inter-meeting move. (The cavalry had come in time.) We rapidly completed the rotation to Small Cap and Value equities at very favorable levels. And the markets bounced back.

But the important point here, we believe, is not the effective timing of the rotation as much as the fact that during the MLK holiday crisis our clients' portfolios had already been positioned conservatively, able to take a body punch.

After the inter-meeting rate cut, markets rallied for a few weeks with the Fed lowering interest rates again and introducing a number of new-fangled facilities to abate the credit crunch. But by early March, the second massively negative event occurred: news of something not anticipated, something very scary to us. Carlyle Capital (a hedge fund affiliated with Carlyle Group – a very large, very smart private equity firm) said they were struggling with margin calls – the “kiss of death” for leveraged financial firms. What was shocking is that Carlyle wasn't playing in the sub-prime playground; it was invested only in high-quality mortgage-backed securities. Nevertheless, banks were afraid that they were going to lose on the loans they had made to Carlyle, even though Carlyle was only invested in “safe” assets.

To bottom-line it: this meant that the credit crunch was infecting all sorts of high-quality assets, forcing high quality firms to fail. To us this was the proverbial canary in the coal mine. And with the price chart of the equity markets looking suspiciously like October 1987, on March 7th and 10th we sold the assets that we had purchased in January taking only a de minimis loss.

We felt that gate opening up again, another outlier to be withstood. And as Weyland Capital Management is an investment management house, not a speculator, (most of our clients invest the totality of their financial assets with us), our prime objective (as Captain Kirk might have said) is to preserve our clients' capital. And so we did.

On March 10th when we sold our last tranche, Bear Stearns closed at \$62.30 per share while its CEO Alan Schwartz was saying in a company statement that “Bear Stearns' balance sheet, liquidity and capital remain strong.” This was admission of a potential banking collapse.

For an instant the wave had swamped the boat, the outlier had been observed, the gates of Hell were wide open. But would they stay open?

Four days later on March 17th, Bear Stearns would be bailed out by the Fed “taking actions that have not been used since the Great Depression and a few that heretofore have never been used.” Bear Stearns agreed to be purchased by JPMorganChase for \$2 per share (subsequently raised to \$10 per share).

Had Bear Stearns gone bankrupt, a 20% down day in the stock market and the risk of the entire system at least temporarily buckling would have been within the realm of possibility. Given our conservative tactical posture (and our comprehensive diversification), had this meltdown occurred our clients would have been significantly better off “than the next investor”.

But the system did not meltdown because the Fed came to our rescue again. Therefore, our conservative posture was not immediately rewarded. Nevertheless, as investors we are proud that we were able once again to take significant steps to create portfolio resiliency, just days before all Hell broke loose, and also proud for not being 100% reliant on the Fed to consistently make the right short-term call.

Where are We? And Where to Now?

The big picture of what we are experiencing currently is a credit crunch similar to the S&L crisis of the late 1980s and 1990 with a softening labor market. What’s different this time is that housing prices nationally are being marked down more today than at any time since the Great Depression. Plus, volatility in the stock market has been overwhelming. In fact, as measured by the number of large positive and negative days, the stock market has been neck and neck with 2000 having not seen a more volatile start of the year since the Great Depression.

Moreover, the Fed has exhausted nearly all the “good and sound” ammunition that was made available to it from Chairman Volker’s courageous fight against inflation 28 years ago. Now the Fed is using truly extraordinary measures that by law can only be used in “unusual and exigent circumstances”. Although these actions quite possibly have avoided deflation in financial assets (though more time is required to “know” this), the Fed has at the same time likely increased the future risk of moral hazard and future government interference in capital markets.

More directly relevant to us “small” investors, it is almost certain that the Fed has unlocked the inflation genie. It isn’t imminent, but it is coming.

Given the carnage going on in the credit markets and the historic volatility, we have been reasonably content to be modestly defensive these past four weeks. We don’t want to try to “shoot the lights out” if it means playing Russian Roulette with our portfolios. By being defensive, it is possible that we may trail our benchmarks this year. This is not our forecast, just a possibility. But in times like this past month, with investment banks and hedge funds blowing up, with seemingly safe “cash” investments like auction rate securities being marked down up to 20%, and with money market management firms taking out lines of credit in order to ensure that their “buck isn’t broken”, we want to be consistent with Will Rogers’ quip about being more concerned with the return of his money rather than the return on his money. Funny, that quip seems earnest now, not humorous at all.

Having said that, we are observing the markets closely as to when we can increase our equity weightings back to normal policy levels. Our best guess is that we will be able to dollar-average back in over the coming quarter or so, possibly sooner. And as part of our objective to structure our portfolios more effectively for the next long cycle including the heightened inflation risk, you may see a couple of changes in securities. As we implement them, don’t be surprised if we take temporary positions – in super volatile times like these we usually do this for risk control and sometimes for temporary insurance.

Although it may feel like a lot longer than nine months, it is our hope that by the end of the year markets will recede from their current outlier behavior back to more normal behavior.

Much Pain Has Been Felt

On a personal note, and tying back to my old Columbia crew days, I'd like to share with you an email I wrote to Weyland staff late in the evening of Friday, March 28:

"In talking with Polly tonight, I realized that the bow man of my crew boat was a successful trader at Bear Stearns. Many memories as a kid – he was my closest friend as a freshman/sophomore at Columbia - although because of my spirited independence, I lost touch with him long ago.

This guy was one of, I think, five sons, raised by his father, a teacher (his mom died when he was young). He is classically Bear Stearns, a firm who brought in street-smart, usually poor, but exceedingly hard working folks. Anyway after almost 30 years at Bear, he is/was a managing director there in fixed income. Who knows he could have been one of the eager-beavers who brought the firm down. All I know is that he lost more than 95% (many millions of dollars) of his peak net worth – a bitter pill indeed.

At the end of the day, I'm proud to work at a firm that acts in its clients' best interests by developing and managing balanced strategies that are meant to quietly succeed in any environment. But we can't get too cocky, there is plenty of pain out there and plenty more to come. Let's keep doing our jobs, working hard for our clients, careful not to take too many risks. If we're smart, and fortunate, our clients will survive - and quietly thrive. And so will we.

Thank you for your very good, hard work. And let us never forget those that fell before us."

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Finally, let me close by thanking all of you for your support and confidence during this challenging period.

Bob Henkel
Chief Investment Officer

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