*The following is an excerpt from our letter for the fourth quarter of 2008:*

This past year, and in particular the quarter just concluded, saw historic declines in the prices of virtually every form of investment. The market experienced widespread, indiscriminate, panic selling, and corresponding panic buying of treasuries.

Given the speed and severity of the declines, and the severity of the economic recession, it is natural to wonder whether this downturn will resemble the Great Depression. While we don't make economic forecasts, we believe it is appropriate to share with our clients why we think a deflationary Depression is very unlikely. It provides a backdrop to understanding our investment activities, as we have invested briskly into the downturn, and are now fully invested (a statement it has taken us six years to make).

## ***Is This the Beginning of a Second Great Depression?***

First, if we are correct that this isn't the beginning of a second deflationary Great Depression, you should understand what we think that means this year for the stock market: we have no idea. Our conclusion impacts what we own, not when we think stock prices will change.

Second, let's be clear what we mean by the Great Depression. Downturns and recessions are a necessary evil of capitalism. In the ordinary course of events, the economy will pull itself through a normal downturn. We distinguish the Great Depression primarily by the severity and duration of its effects: a near-total stock market crash, widespread credit contraction with thousands of bank closings, and a deflationary spiral that cut economic activity nearly in half, with unemployment rising to 25%, idled production, wide-spread shortages of basic necessities like food and housing, and a duration of more than a decade. There have been many downturns, but only one turned into the Great Depression. Below we compare several recent downturns to highlight just how different the Great Depression was:

| | Real GDP | Inflation (Deflation) | Nominal GDP | Peak Unemployment | Market Peak to Trough |
|---|---|---|---|---|---|
| 1930-1933 | (29%) | (23%) | (45%) | 25% | -86% |
| 1973-1975 | 4% | 31% | 35% | 9% | -48% |
| 1980-1982 | (1%) | 27% | 26% | 11% | -27% |
| 1990-1991 | (0%) | 9% | 9% | 7% | -20% |
| 2000-2002 | 6% | 8% | 15% | 6% | -49% |

What caused the Great Depression to be different? *The key factor that turned an economic downturn in the 1930s into the Great Depression was the government's initial deflationary policy.* In the first four years, as the banking system collapsed, the government responded by further shrinking the money supply, raising interest rates, raising taxes and attempting to balance the federal budget. These actions amplified the normal contraction. There was a recovery after these initial catastrophic years, but it was muted and slow. Our goal here is not to address the various policy responses over the next decade (which remain controversial), but to highlight the critical role played by the initial deflationary response of government. In our opinion, the verdict of history is clear that this deflationary response was a mistake, and that it was the primary cause of the spiral into Depression.

In 2002, years before this current crisis and prior to his becoming Fed Chairman, Ben Bernanke gave a speech in which he laid out the steps the Federal Reserve must take to avert deflation if it were to again become a reasonable possibility. In it he described a wide variety of methods that the Fed had at its disposal, beyond simply driving the short term Fed Funds rate to zero. Today, as the current Federal Reserve Chairman, he is putting those methods into action, establishing programs both to support banks and to lend directly to the credit markets. These programs are a bewildering array, but the important point is that the Fed is feeding money to the markets with a firehose. So far, the Fed (with other agencies) has announced a colossal $8 trillion of potential support to a credit market that was roughly $50 trillion in size. The message is clear: the Fed will support the banks, and if the banks will not lend, the Fed will.

This approach is not a new one. Even before the early mistakes of the Depression, this conclusion had been reached by others. The Economist magazine recently re-ran this quote from an 1873 issue:

> In wild periods of alarm, one failure makes many, and the best way to prevent the derivative failures is to arrest the primary failure which causes them. The way in which the panic of 1825 was stopped by advancing money has been described in so broad and graphic a way that the passage has become classical. \`<u>We lent it</u>,\` said Mr. Harman, on behalf of the Bank of England, \`<u>by every possible means and in modes we had never adopted before</u>; we took in stock on security, we purchased Exchequer bills, we made advances on Exchequer bills, we not only discounted outright, but we made advances on the deposit of bills of exchange to an immense amount, in short, by every possible means consistent with the safety of the Bank, <u>and we were not on some occasions over-nice</u>.

It is not important whether one agrees with this policy (although we generally do), or thinks it will lead to other negative consequences (we definitely do). *What matters is that the government is charting a course which is the polar opposite of the early 1930s response.* It is conceivable that even these strenuous efforts will fall short, but they are so far removed from the behavior of the early 1930s that any forecast of a deflationary Depression is highly speculative. Adversity lies ahead, but for investors with a reasonable time horizon, we don't believe that deflation is a high probability risk. And it would take much more than an occasional report of a negative CPI number, or temporarily low interest rates, to change our opinion.

### ***But Isn't the Market Pricing for Deflation?***

Financial markets are pricing assets as if deflation is a near-certainty. The value of equity and debt issued by the world's businesses has been severely marked down, suggesting the most pessimistic economic assumptions. At the same time, treasuries have soared, and now pay zero and even negative yields, suggesting that investors believe cash will buy more in the future than it can today. To those who believe that markets are efficient, reflecting a greater collective 'wisdom of the crowd', this is a powerful, mega-trillion dollar prediction of deflation, not something to be trifled with.

But that is not our view. We believe that this pricing reflects the panic of investors, not a cool, calculated re-appraisal of future economic conditions. In our last letter we referred to the "increasingly frantic search by investors for something safe, and the growing fear that perhaps nothing is." This fear exploded into panic in the fourth quarter, and manifested itself as the indiscriminate sale of almost everything and the purchase of treasuries at any price. It is hard to imagine stronger evidence of panic than treasuries yielding less than cash under the mattress. We believe this has created a bubble in treasuries. For the buyer of treasuries, caveat emptor (and for the seller of stocks, caveat vendor).

This situation is exacerbated by the Fed's efforts to drive down rates, to stimulate lending activity and to avert a deflation. As we have indicated, we believe these efforts are likely to be successful eventually, but they do have consequences.

As so often, Warren Buffett has said it better than we can. In his October 16, 2008 New York Times article, he wrote:

> Today people who hold cash equivalents feel comfortable. They shouldn't. They have opted for a terrible long-term asset, one that pays virtually nothing and is certain to depreciate in value. Indeed, the policies that government will follow in its efforts to alleviate the current crisis will probably prove inflationary and therefore accelerate declines in the real value of cash accounts.

### ***If This isn't the Great Depression, is Now a Good time to Invest?***

When financial markets are experiencing extreme events, there is a tendency for investors to extrapolate current conditions into the future. In just the last eight years we have witnessed bubbles in technology stocks, real estate, China and other international markets, leveraged buyouts, energy and commodities, and (we argue) in treasuries today. *In each case, the more extreme pricing became, the more likely it seemed to continue, the* *more money flooded into it, and the more proponents explained that "this time is different."* The most remarkable thing about these bubbles is that they are not remarkable at all, but are routine by-products of financial markets. That is, they routinely occur; in their actual course and duration, they are violent and unpredictable. For an excellent article on how human behavior inevitably leads to bubbles, see "Pop Psychology" in the December, 2008 issue of the Atlantic.

The same tendency to extrapolate from current conditions applies to panics just as it does to bubbles. Today, as in prior downturns, there is ample reason for gloom. The further prices fall, the further it seems they could fall. The outlook for the economy is bleak and we are inundated with sour economic statistics, negative headlines and gloomily persuasive pundits. But as bad as the economy is (and will likely get), stock markets and economic statistics do not necessarily move in tandem. The following table, which covers the same downturns and market declines presented earlier, highlights strong market recoveries that began as unemployment was reaching its worst levels:

| | Peak Year Unemployment | Stock Market Performance, at Peak Unemp. | 4-6 year Market Recovery |
|---|---|---|---|
| 1930-1933 | 25% | +54% | +200% |
| 1973-1975 | 9% | +37% | +164% |
| 1980-1982 | 11% | +21% | +148% |
| 1990-1991 | 7% | +31% | +115% |
| 2000-2002 | 6% | +29% | +83% |

We are not making a prediction (and this downturn is likely to drag on), but simply illustrating how difficult it is to time investments based on the economic outlook. Just as economic and market statistics tend to look wonderful at the peak (before a decline), they tend to look absolutely awful at the bottom. Not surprisingly, the cheapest prices will tend to coincide with the worst outlook.

This still leaves the question of how much decline is "enough"? It seems certain that the economy will get worse before it gets better. How does an investor decide when to act? After all, no matter how much the market has already declined, it can always decline more.

The answer to this question is valuation. The market's behavior is fundamentally unpredictable; its leaps and falls will never provide a sound basis for decision. Instead, we rely on information that can be analyzed to provide a sound basis for decisions: the quality and value of individual companies. We determine what we are willing to pay for a company we want to own, and then we wait for the market to offer us that price. Value investors often refer to the discipline of valuation as an "anchor to windward," anchoring decisions to something firm, particularly in a heavy storm. Our conclusions are approximate rather than precise, but they help filter out the noise, and they lay a firm foundation for decisions in times of great uncertainty.

This is why we are now fully invested. In our opinion, stocks (and many other financial assets) are cheap, notwithstanding the recession. There are many companies we would still avoid, but there is no need now to trade quality for price: we have never seen more things we want to own at prices we are willing to pay. Great companies, with fortress balance sheets, powerful competitive advantages and superior management teams are available at wonderful prices.

Christopher J. Harrell, CFA
William H. Harrell, Jr.

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