Sizemore Capital Management

2008 Fourth Quarter Investment Outlook and Commentary

December 31, 2008

To Our Investors,

If you are reading this letter, congratulations. You have just survived what was arguably the most painful year in the history of the U.S. capital markets. The good news is that our portfolios performed better than the market averages. The bad news is that we were not immune to the "Great Deleveraging" of 2008, and we too took losses in this most brutal of markets. In a typical bear market, there is rotation among asset classes. For example, during the 2000-2002 dot-com bust, mainstream U.S. stocks fell by roughly half and tech stocks plummeted by 80%, but investments that paid solid income performed well. Real estate investment trusts and high-dividend-paying stocks posted solid gains. Master limited partnerships ("MLPs"), which primarily invest in durable assets like oil and gas pipelines, had phenomenal returns in those years. This was not the case in 2008, however. Month by grueling month, literally *everything* except U.S. Treasury bonds fell precipitously in value.

So, what happened? In one word, "debt." Credit is the lifeblood of our modern economy, and when the large investment banks began to face solvency issues due to their excessive bets on the U.S. housing and mortgage markets and their derivatives, it set into motion a chain of events that led us to where we are today. Imagine that you are a hedge fund manager. You borrow money from your prime broker to buy investments. This is what we call "buying on margin." Let's say you borrowed a fair amount of money at a 3% interest rate and that you were able to turn around and invest it in a basket of MLP oil pipeline stocks paying 6%. You're now making 3% on the spread, using borrowed money. This is essentially what commercial banks do as well; they borrow from depositors and the Federal Reserve at low rates and then make loans for homes, autos, businesses, etc. at a higher rate, making money on the spread. This is practically a license to print money, until the unthinkable happens.

In 2008, the unthinkable happened. The large banks, reeling from losses on their mortgage portfolios, stopped lending. Suddenly, all of these leveraged trades could no longer be funded. If you are the hedge fund manager in our example, how do you pay back your loan if you cannot extend it or find a new lender? You do what anyone facing bankruptcy would do; you sell your assets. In this case, the hedge fund manager is forced to dump his high-quality MLP stocks on the market at ridiculously low prices because there are thousands of other large investors doing exactly the same thing. A downward spiral develops in which there are desperate sellers forced to sell at any price and virtually no buyers. This is what happened in the fourth quarter of 2008 to stocks, real estate, infrastructure assets, MLPs, and most non-Treasury debt. For all intents and purposes, leveraged investors were forced to dump quality assets in a desperate attempt to pay back their loans in what will probably be known by future historians as the biggest margin call in history.

In this environment, Sizemore Capital's Tactical Portfolio, despite being composed of a mixture of high-quality growth and income-paying assets lost 14.6% on average for the three month period ended December 31, 2008 compared to a loss of 21.9% for the S&P 500 over the same period, including dividends. We beat the market for the quarter, but we have to view this as a Pyrrhic victory at best.

The good news is that our portfolio contains rock-solid investments that should rebound strongly in 2009. Sizemore Capital does not buy speculative junk for its clients. Our basic investment rationale is valid, and we believe that 2009 will prove this. In the commentary below, we will examine our positions one by one and give our thoughts on their prospects in the new year.

Tactical Portfolio Review

We will start with our biggest success of 2008. On November 20, we sold our dollar/euro play, DRR, for a profit of approximately 36% in just three months. That's not too shabby given that it was during the deepest bear market in living memory. By mid summer, negativity toward the U.S. dollar had reached a fevered pitch, and the greenback had reached record lows against the euro and the British pound. We never understood the bitter vehemence of this negativity. Sure, the dollar is a poorly managed currency, and the U.S. government is not fiscally responsible. The United States also imports far more than it exports. These are bad fundamentals for a currency. The problem is, the British pound shared *all* of these characteristics with the dollar, and the euro shared most of them. We agreed that the dollar was "bad," but we fundamentally disagreed that it was *uniquely* bad. To us, the pieces were in place for a low-risk, high-return trade. Extreme sentiment had led to an unsustainable trend, and we bet the other way, shorting the euro.

Our only surprise was how quickly our trade paid off. Due to the implosion of the world credit markets, investors dumped foreign currencies and brought their cash home, in dollars. As a result, we were able to enjoy profits that would normally be earned over the course of a year or more in only three months.

Our largest position remains the S&P 500, at 35%. We still believe this position makes sense. When we first made this allocation in the third quarter of 2008, the bear market had already pushed the entire U.S. stock market into attraction valuation territory. We fully expected the market to turn around in the fourth quarter, and we wanted the broadest exposure possible. As the carnage of the fourth quarter proved, we were far too early in predicting a turnaround. That said, we believe our reasoning is now stronger than ever. At current valuations, American blue-chip stocks are the cheapest they've been in decades. And in the S&P 500, we have a broad basket of them.

For our taxable accounts, we applied a "tax loss harvesting" strategy on this position. We sold one S&P 500 position, in SPY, and took the loss, which will be a tax benefit for those investors when they file their 2008 tax return. We then took the proceeds and invested them in IVV, an S&P 500 index ETF that is virtually identical to SPY. Our investors can now enjoy the benefits of a tax loss while still maintaining their exposure to the S&P 500. In the non-taxable accounts, such as IRAs, we kept the original position in SPY, as replacing it with IVV would only incur additional brokerage fees with no tax benefit.

Our current allocation could be described as a core-satellite strategy. The S&P 500 provides the primary core of the portfolio, and the remaining positions give us exposure to more targeted opportunities, such as the euro/dollar trade, the luxury retail sector, municipal and corporate bonds, and infrastructure.

Of the satellite positions, the luxury retail sector (ROB) is one of our largest at 15%. We explained our rationale for overweighting this sector in the July issue of SFO Magazine. To us, this was the perfect contrarian play. The luxury sector was cheap measured by historic valuations, conservatively financed with very little debt (and thus negligible potential for bankruptcy or financial distress), and highly profitable even in a recessionary environment. Furthermore, equity analysts were almost universally bearish on the sector, and extreme sentiment of that nature generally signals an imminent reversal. After all, if *everyone* hates it, who is left to sell? This looked like the perfect investment for the next 9-18 months. This is why the sector's terrible performance during the fourth quarter is particularly frustrating for us. We still believe in this trade. As we said above, ROB contains some of the best luxury brands in the world, brands that command a premium sales price in any economy.

This period of gloom will eventually pass, and when it does affluent people will continue to buy Coach purses, Tiffany diamond rings, and Dom Perignon champagne. People accustomed to such luxuries don't give up on them easily, and luxury brands have enormous growth potential in China and the rest of the developing world. Emerging markets represent 30% of all luxury sales, compared to just 20% in the United States. So, if you believe in the long-term growth prospects of Asia and South America, you believe in luxury.

Naturally, during the panic selling of the fourth quarter, none of this mattered. Luxury retail was the proverbial baby that was thrown out with the bathwater. This cannot last forever. When the broader stock market finally turns around, we believe luxury retail will be one of the strongest performing sectors.

We continue to maintain significant exposure to infrastructure investments (15%), divided equally among FMO, a closed-end fund that invests in oil pipelines; MFD, a closed-end fund that invests in utilities and senior secured debt; and PXR, an ETF that invests primarily in companies that build basic infrastructure in emerging market countries. PXR is a recent addition, added in mid-December.

FMO and MFD been disappointments thus far, losing nearly half of their value during the quarter. Both of these funds were particularly susceptible to panic selling due to the fact that they employ leverage. As in our example of the hedge fund above, FMO and MFD borrow a modest amount of money in order to generate higher yields. In the environment of terror surround the market, anything with the word "leverage" in it became toxic waste and was summarily dumped. Suffice it to say, the market overreacted. FMO and MFD are solid funds and are conservatively financed. Consider the following excepts from an October press release by FMO's management in response to investor fear:

"FMO Provides Update on Asset Coverage Ratio"

Over the last several weeks, we have been in the midst of an unprecedented period of volatility for the global financial markets. This volatility has gravitated into nearly ever sector of the investment world, including master limited partnerships ("MLPs"), in which FMO primarily invests.

FMO utilizes leverage as part of its investment strategy. The Fund has recently refinanced its leverage through a prime brokerage account that has an evergreen renewal feature with a 180-day cancellation period. Under the terms of this agreement, the Fund must post collateral against the leverage of at least 200% of the amount of leverage outstanding. As of October 10, 2008, the Fund's percent leverage, net of cash and pending trade settlements, was approximately 21.0%, which represented a coverage ratio of approximately 476%

Link to FMO press release

FMO has more than twice as much collateral as needed, meaning that the fund's chances of financial distress are virtually nil. MFD also has only modest leverage, and we judge that the company has no legitimate risk of distress. We are frustrated that these two funds have fallen so far in price, but we are not concerned. Both are paying double-digit dividend yields, so we are getting paid to wait for a recovery. We can milk these dividend payments indefinitely until the prices eventually return to sanity, and that is exactly what we intend to do. We still believe in the growth story behind infrastructure. If our current recession lingers, this only increases the attractiveness of the sector. Some of America's biggest infrastructure projects in history were "make work" programs started by the federal government during the Great Depression, and the incoming administration has voiced enthusiasm for such projects. If we are patient, these trades should be solid moneymakers for us.

This same line of thinking gives us extreme optimism for PXR. Congress and the incoming Obama Administration have committed to stimulating the economy with public works projects. Meanwhile, the biggest growth story here is in India (as we wrong in the Daily Reckoning as far back as 2006). India's infrastructure is absolutely horrid and is a major impediment to continued economic growth. This will be remedied by necessity. The same is true of most of the rest of the developing world as well, as population growth and urbanization have created new demand for everything from roads to sewers to electrical plants. We do have a lingering concern that the global recession will put some projects on hold. We also worry that China will "blow up," as most analysts believe that China's economy is loaded with dangerous excesses. Beijing's new airport has a single terminal that is larger than the entirety of London's Heathrow airport. Is this perhaps a contrarian signal that China has been overbuilt? This is a question we will keep in the back of our minds as we monitor the progress of our investment in PXR.

Our bond positions have been a mixed bag. Our 10% allocation to investment-grade corporate bonds (LQD) fell in value, but much less so than our stock positions. Meanwhile, it paid an annualized yield of over 6%. As fear in the credit market subsides, funds should shift out of Treasury bonds and into other sectors, such as corporate bonds. In the meantime, we will benefit from the steady income that this sector offers. We intend to hold this position well into 2009 or until corporate yields return to their historical spreads over U.S. Treasuries.

Our investment in the municipal bond sector has been much more problematic. During the bear market purge, our "conservative" position in VKQ lost nearly as much as the major stock market averages. Like FMO and MFD, it fell severely out of favor due to the modest leverage it uses. Furthermore, the bonds it owns, along with virtually all non-Treasury debt, plummeted in value due to the general state of upheaval plaguing the credit markets. In this environment, California, the biggest state in the Union by economic power, was unable to issue bonds. Governor Schwarzenegger actually joined the queue of those asking the federal government for emergency funding! As a result, the yields offered by this sector have now reached almost unimaginable levels. Some high-quality municipal bonds with very little default risk are offered tax-equivalent yields of well over 10 percent!

At time of writing, VKQ is trading at a 10% discount to its net asset value and sports a yield of 9.5%— tax free. This equates to a 13.2% taxable equivalent yield. Usually, you can't get a yield that high on a junk bond, let alone a stable municipal bond. Given that income taxes will almost certainly be rising under the new presidential administration, we believe there will soon be a strong demand for municipal bonds. We believe it is highly likely that we will recoup our paper losses on this position relatively quickly and ultimately see substantial gains. In the meantime, we're enjoying a 13.2% yield. This position will likely continue to be a part of the portfolio for at least the next several quarters.

With so many U.S. stocks at attractive valuations not seen in a generation, we remain underweighted in international equities, including emerging markets, though we continue to see value in Taiwan (EWT). Over the course of the fourth quarter, we increased our allocation to Taiwan from 5% to 10%. Unfortunately, we were a little too early. Taiwan, along with the rest of East Asia, was hit hard in October and November by the collapse in global exports and fears that the recession will be deep and long lasting. We believe this short-term negativity toward Taiwan is overdone, however, and that the country stands to benefit from a number of positive trends, not least of which is a thawing in its relations with mainland China, its historic rival. Consider the following press release:

"Taiwan, China Sign Historic Trade Pact"

CBS/AP November 4, 2008

Taiwan and China set aside decades of hostilities Tuesday and agreed to drastically expand flights and allow shipping links across the Taiwan Strait - a potential hotspot that has long threatened to become a war zone.

The historic deal highlighted the dramatic improvement in relations in the past half year between the rivals that split amid a bloody civil war in 1949. They agreed Tuesday to hold high-level talks every six months and focus on building closer financial ties in the next round of meetings....

Tuesday's agreement - which becomes effective in 40 days - more than tripled the number of weekly flights to 108. It also allows planes to take off from a total of 21 cities. Under the deal, cargo planes can also begin flying the route, with 60 allowed each month. In the past, cargo ships had to sail to the Japanese island of Okinawa before going to the other side. Tuesday's agreement allows them to sail directly across the 100-mile-wide (160-kilometer-wide) Taiwan Strait.

Link to original Taiwan article

Jim Rogers, the renowned "Investment Biker" and "Adventure Capitalist" is on the record recommending Taiwan. While we don't believe in mindlessly copying successful "celebrity" investors, we do take some comfort in investing with the man who correctly forecast the 2000s commodity bubble and who helped George Soros earn billions in profits in his hedge funds during the 1980s. Taiwan is one of the cheapest markets in the world and is in a prime position to benefit from the continued growth of mainland China. We want to give this investment time to realize its full potential. We may end up holding this position for multiple years if the fundamentals stay positive.

Concluding Remarks

The great French scientist Louis Pasteur was quoted as saying "fortune favors the prepared mind." While we can never know with certainly what the future will bring, we can certainly prepare responsibly and position our portfolios with prudence. Today, we are allocated heavily to stocks, which are as cheap as they have been in a generation, and to solid, income-producing assets. We also remain 5% in cash, giving us the flexibility to allocate more funds to existing positions, rebalance the portfolio, or add a new position that we find attractive.

After a year like 2008, it is tempting to sell everything, put the cash in the bank, and simply give up on making money. We believe, however, that this would be foolish and short-sighted. In this business, money is made by buying low and selling high. The market can go lower in the short term. This is true. But at these levels, we can afford to wait. And the high dividends and interest payments generated by our portfolio make waiting far less painful.

Here's to 2009 and the opportunities it will provide,

Charles Sizemore

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