



CAZ INVESTMENTS

A Wealth Management Firm

**OFFICERS**

KATHRYN E. HAYDEN  
*Director of Marketing*

J. CASEY HODGES  
*Chief Operations Officer*

AIMEE B. McCRORY  
*Executive Vice President*

MICHAEL A. MEAGHER, CFA  
*Executive Vice President*

STEPHEN N. MORTENSON  
*Executive Vice President*

CHRISTOPHER A. ZOOK  
*Chairman & Chief Investment Officer*

4th Quarter 2008

**CAZ CORNERSTONE PORTFOLIO  
Quarterly Update**

Where does one start when trying to recap a year like 2008? Do we focus on the virtual collapse of the commercial banking infrastructure around the world? Should we spend time on the elimination of Bear Stearns, Lehman Brothers, Merrill Lynch and Washington Mutual? Maybe we concentrate on the disintegration of the largest insurance company in the world, AIG, and the nationalization of Freddie Mac and Fannie Mae? Finally, should we contemplate on the fact that 2008 was the worst year for stock markets around the world in two generations? My guess is that people would prefer to write off 2008 as a bad dream and focus on the future. We agree.

The most amazing thing for us, when we look back at 2008, is how the warning signs were there predicting the coming storm. We expounded on it to a great degree in our January 2008 letter, and we will detail those comments below. The thing that no one could have forecast, though, was the impact that the de-leveraging of the world economy would have on asset prices. To think that we ended up with what amounted to a worldwide margin call as a result of the government's decision to let Lehman Brothers fail is truly mind boggling. Certainly, the government did not think it would get as bad as it did! When one looks back, though, with a self-critical view of 2008, we see there were plenty of warning signs. To name a few:

1. The air was clearly coming out of the housing bubble.
2. Consumer savings rates were negative and had been for several years.
3. Profit margins were at historically peak levels.
4. The use of leverage in the investment world was remarkably high.

What the world never seems to remember is that when prices start to fall, they always seem to fall much faster and farther than people possibly can foresee.

**How Close Were We to Reality?**

We say it every year and we will continue to say it: we really don't like making predictions from a top down perspective. We are stock pickers, and we focus on what is happening at the companies first. We have to pay attention to what is happening at the macroeconomic level so we can make estimates of how those forces will impact our companies, but it is secondary to our company work. However, if we expound our view, it only makes sense to evaluate those predictions. Here is the exact reprint of our 2008 projections from last year's letter (in italics) with the follow-up of how that prediction turned out:



Here is what we believe will occur in 2008:

- *The Federal Reserve will continue to lower interest rates to combat the growing risk of a recession for at least the first few months of the year. Then the Fed will become increasingly concerned about the impact of those rate cuts on the long-term inflation rate, and they will stop lowering rates because of those fears.*

The Fed did indeed lower interest rates for the first part of the year, took a pause, and then was forced to extreme levels by the Lehman debacle. Interest rates are now effectively ZERO.

- *Company cash flow growth will begin to slow as consumers begin to reign in their expenses and corporations begin to reduce capital expenditures in the softening economy. Street consensus for earnings growth in 2008 is around 8% right now. We believe that the actual number will be approximately 2–5%.*

We were right to be below consensus; we simply did not foresee the cliff that the economy would fall off because of the freeze up of the credit markets.

- *This disappointment in profit growth and the economic slowdown will cause valuations to decline slightly. The good news is that valuation levels are not expensive right now on a historical basis. The bad news is that if earnings growth slows materially, those valuations are still at risk. We feel that earnings multiples will likely stay in a range between current levels and a decline of 3%.*

Again, right in concept, wrong in magnitude. Valuations were not expensive, but the decline in earnings became so dramatic that panic kicked in and valuations went to extreme, undervalued levels. Sentiment is always hard to predict, and we certainly did not see the panic coming that eventually took hold of the world.

- *Volatility is here to stay for awhile, and we expect this year to be in line with historical levels.*

Boy was THAT an understatement! Volatility stayed and expanded dramatically as a result of the panic and uncertainty.

- *Housing prices will accelerate their decline as “patient” sellers become “panic” sellers. We believe that in order for housing prices to return to the historical trend, they must decline by approximately 15% from their peak.*

Very accurate. The decline in housing prices has now brought us very close to the historical trend.

- *Foreclosure rates will be substantially higher than most would imagine and could reach record levels.*

Very accurate. Not many people expected more than 30% foreclosure levels in some areas!



- *We believe that the political landscape in Washington will become significantly less favorable to the market, regardless of who wins the election.*

We wish we had this wrong. Right now, the government has historical low levels of credibility with Main Street.

- *We will hear how many of the leverage buyouts from the last four years will run into trouble making their debt payments, and we will likely hear about several that have to significantly restructure.*

Very accurate, albeit, conservative. Instead of several we should have said dozens and dozens!

- *The economy will very likely slip into a recession.*

Very accurate.

- *The year will be marked with debate as to whether or not the result of this economic slowdown will stop at a recession or if we will slide into a period of stagflation.*

That debate did occur until the Lehman bankruptcy. Then, of course, the dialogue turned to recession or depression!

- *As a result of these projections, we believe that 2008 will be a very flat year. The result of the math above indicates that if we have 2–5% cash flow growth and a 0–3% decline in valuations, we will experience a range of -1% to 5% return in the market this year.*

Hmmm, we would have to say we got that wrong! We were right on all the inputs and simply underestimated how much the market could sell off from those inputs. Naturally we did not expect the kind of disintegration of the financial system, but we should have been more bearish based on the negative view we had of the world.

- *What could make it worse? One thing that could feasibly occur to cause a lot more downside would be if the earnings growth rate for the market did not just slow, but actually went negative. **If** earnings begin to decline, we would expect the market to decline by at least the amount of that negative growth rate.*

We certainly wish we had put that entire paragraph in bold and underlined it. The reality of what happened is encompassed by our statement above. It appears that earnings declined by approximately 25% (depending on the final numbers from 4<sup>th</sup> quarter announcements). The market not only declined by that drop in earnings but added another 15% decline from valuation compression. Simply stated, when earnings go down a lot and people panic, valuations drop as well. This is how we got to a 40% decline for the year!



## **So Now What?**

Here we go again! We don't like going out on a limb with what we see for 2009, but people ask us to, so we are obliged to try our best to see the future. Here is what we think is possible for 2009:

- The Federal Reserve and Central Banks around the world will use every tool in the tool chest to try and rescue the banking system. Rates are already near zero in many countries, so those efforts will include the expansion of the Central Banks' balance sheets, reduced capital requirements, direct purchase of securities and anything else they can think of. Then toward the end of the year, as things begin to stabilize, the Central Banks will have to think about the future inflationary ramifications of the massive increase in money supply. They will just think about it, though. We do not think they will begin to tighten credit in 2009.
- The housing market in the US will bottom. Yes, that is what we said. There is a bottom, and it is likely to be reached in the summer/early fall of 2009. That does not mean that prices will go up, but it means that they will most likely stop going down.
- The US government will announce one of the largest fiscal stimulus programs in history. While that is a given based on what we are hearing from Washington, the surprise may very well be the sheer magnitude of the programs.
- The result of the stimulus effort will be one of the largest deficits, as a percentage of GDP, that has ever been seen.
- Long-term interest rates will begin to climb by the end of the year. As the world begins to recognize that the economy will indeed recover at some point in the future, the flight to safety will begin to reverse and investors will realize that the true price of the bailouts will be substantial future inflation. When this happens, government bonds will begin to sell off and rates will go much higher.
- At least one state or large municipality will require federal assistance to stay solvent. Clearly the government will oblige, as it would be impossible to justify using taxpayer money to save AIG and not use it to save a STATE!
- Unemployment rates will continue to increase in the first half of the year and may approach 9% before stabilizing and improving toward year end.
- Corporate bond spreads will stay very high as defaults begin to accelerate and then will begin to improve toward the end of the year as defaults begin to peak.
- Stock prices will continue to bottom in the spring/summer and volatility will begin to drop as investors enter the "waiting mode." As investors are waiting for a "sign" that all is clear and it is safe to buy stocks, we expect stocks to stay choppy. We do expect stocks to have an upward bias during this time frame and that company guidance will begin to be better by the time we hear 3<sup>rd</sup> quarter earnings reports.



The hard part about making projections is that there are so many variables. The thing that always surprises us is how people lose sight of how the results are always going to be centered on cash flow and valuations. Obviously, the macro variables listed above will have a HUGE impact on both of those, but ultimately, if we get the cash flow change and valuation changes close to accurate, the results will be fairly precise.

We are forecasting an approximate 6% increase in cash flow for 2009. That will consist of an initial decline in the first half of the year followed by a recovery as a result of company cost saving initiatives and economic stabilization. That, coupled with a slight increase in valuations, could lead to a decent year of 8–10% returns. Naturally, the devil is in the details, and the fact that we are trying to put a number on this year in the midst of the incredible uncertainty would lead some people to wonder if we need our heads examined! However, we pride ourselves in trying to simplify the complex.

On November 20, 2009, we notified all clients that we felt that we were at the second “Buying Opportunity of a Generation.” The first time we used that phrase was on November 1, 2002. Many people asked how we could be so sure that November 20 was “the day.” The answer, of course, was that we could not be certain, but we felt strongly that a few things were going to happen in the future. First, we felt the world financial system was not going to disappear as we know it. Second, we felt that the economy would eventually recover and that good, solid companies, like those we invest in, would generate cash flow that was higher than current levels. Third, we felt that investors would once again feel comfortable investing in high-quality companies generating solid operating profits. The only thing we never pretend to be able to predict is “when.”

It is quite possible that our forecasts for 2009 could be wrong, but **we emphatically believe that investors need to be buying stocks NOW!** How can we be so sure about that? We feel cash flow generation by the companies in our portfolio will be at least 8% per year for the next five years, and the number could be much closer to a 10% annual growth rate. Therefore, if valuations just STAY at the same levels they are today, which we would argue are a bit low, then we expect to make 8–10% on our portfolio over the next five years. Compared to the alternatives of CDs, money markets and T-bills, that return is extremely attractive. In our opinion, investors have the best opportunity to own the best companies worldwide that we have had since November 2002.

Every quarter for the last few years, we have strongly advised investors to look at their portfolio allocation and make sure it is in line with their goals and objectives. This quarter is no different. MANY clients’ portfolios are now much more conservative than designed, and it is imperative that investors think about the growth of their purchasing power in the future. This is especially true if inflation is as much of an issue as we think it may be. Bonds and cash simply will not provide protection of purchasing power; stocks can, and we believe they will. Please talk to us if you are not sure your allocation is where it should be.

Included with this letter is your 4<sup>th</sup> quarter Portfolio Review. The review includes **a summary of your realized gain and loss information for the quarter AND for the entire year.** The report is also broken down by short-term and long-term gains. So, for a taxable account, your tax preparation should be simple. When paired with the 1099 you receive from your custodian, you should have everything you need for your tax preparers. Do not forget that you can access all of your personal information online at our website, [www.cazinvestments.com](http://www.cazinvestments.com).



We appreciate the confidence you have shown in us. It was a tumultuous year, and we were incredibly impressed with the maturity and sophistication of our clients. Thank you for all the support. It was amazing how many calls we received from clients asking US if we were hanging in there. That was very gratifying and appreciated. Our firm is strong and healthy. We have great people who want to be the best they can be and do the very best job they can for you. We will continue to try and maximize returns for clients and look forward to a calmer 2009! We hope that this year brings many blessings to you and your family.

Regards,

Christopher Alan Zook  
Chairman and Chief Investment Officer