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CAPITAL MANAGEMENT

October 2008

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Seizing your Fannie, Naked Shorts & Shotgun Weddings – A Very Unsexy 3rd Quarter

Economics may be the dismal science, but the 3rd quarter of 2008 has been one of high economic drama. The ongoing financial crisis that claimed investment bank Bear Stearns in the 1st quarter of 2008, and that has upset markets all year, accelerated to push Lehman Brothers into bankruptcy, precipitate the U.S. Government seizure of mortgage lenders Fannie Mae and Freddie Mac, and force distressed insurance giant AIG to take an \$85 billion cash infusion from the government. Some stocks of companies deemed to be at risk were further driven down by short-sellers, those who borrow shares and sell them in hopes of repurchasing the stock at lower prices. Naked short-selling exacerbated this downdraft as some sophisticated investors were shorting stocks without borrowing them first, "naked shorting." The intensified selling pressure on financial stocks prevented many companies from acquiring much needed additional capital from the debt and equity markets. Lastly, shotgun weddings were arranged by various governmental agencies resulting in Bank of America's purchase of Merrill Lynch, J.P. Morgan Chase's purchase of Washington Mutual, and the FDIC negotiated sale of Wachovia to Citigroup which was subsequently interrupted by a higher Wells Fargo offer. The last two remaining large, independent investment banks, Morgan Stanley and Goldman Sachs, effectively elected to become regulated commercial banks with the required reduction in leverage and increase in governmental oversight.

Despite the passing of a \$700 billion U.S. government bailout package for nonperforming loans, the financial markets have responded poorly to these momentous events: The S&P 500 was down 8.88% for the 3rd Quarter, but more importantly shed another 22.9% in the first ten days of October. The S&P 500 is down 38.8% year-to-date. Even the typically safe haven of consumer staples (food & beverage type companies) was down 20.5% year- to-date.

As stocks have pulled back, bonds have been mixed. Government bonds surged, as investors sought their safety amid the turbulence. By contrast, the Morningstar Corporate Bond Index dropped 7.32% for the quarter, and is down about the same for the year. The shift from corporate bonds to government bonds means that the "spread" or difference in yield between corporates and government issues is as high as it's been in years, as investors forego the higher fixed coupon payments of corporates for safer Treasuries. Investors also fled oil and other commodities for most of the quarter on fears of an economic slowdown. The price of oil eased for most of the quarter, dropping from \$145 per barrel to \$80 today.

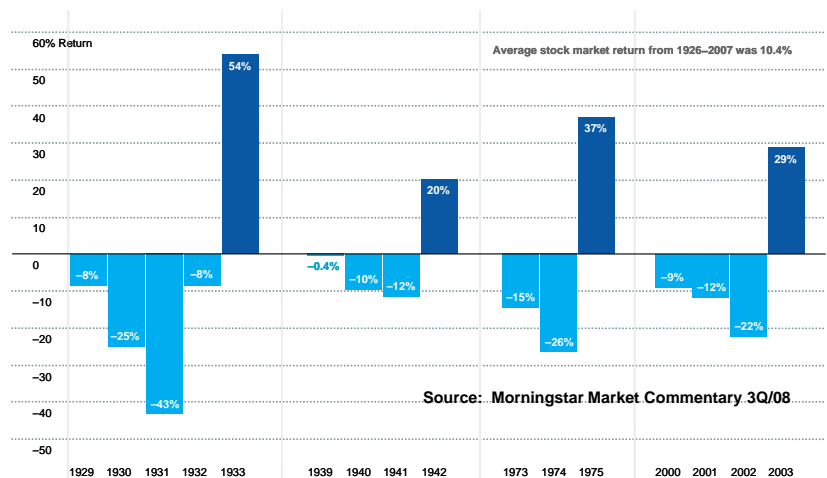
What does all this mean? With each passing decline, more companies with real assets, real profits, and real dividends become overly devalued. When the market will bottom is anyone's guess, but the recent steep declines do smack of panic selling where selling begets selling for no reason other than fear. Time will tell.

What's Next?

Dominating the investment landscape are headlines of doom and gloom. Current transformations in the banking system are rivaled only by the changes that occurred during the Great Depression, and with them Uncle Sam will have to pick up the \$700 billion tab.

Nonetheless, markets have some positive news to ponder. Warren Buffet has been purchasing major positions in corporate America again, including a \$10 billion investment in Goldman Sachs, a \$3 billion investment in General Electric, and his purchase of Constellation Energy. He also remains one of the largest shareholders in Wells Fargo Bank and U.S. Bank. These moves may suggest valuations are attractive. In addition, commodity prices have declined just as precipitously as the stock market which bodes well for a variety of sectors tied to consumers. It is also heartening to know that as quickly as the credit markets tightened they can quickly be calmed if the government plan proves to be as good as advertised.

Periods of Consecutive Negative Stock Returns
1926–2007



The most obvious and frequently asked questions are when will the stock market stop going down and how long will it take to recover? The table above shows past stock market returns during and following the most significant economic downturns over the last 82 years. When recoveries come, and they do, they result in very significant rebounds. This is what makes market timing so difficult. At the time of most despair, the markets can rebound quickly and it's the panic sellers who absorb all of the decline and miss the rebound. I do not like to prognosticate, but if I had to I would guess that the credit markets will recover relatively quickly with the help of massive worldwide governmental intervention and the stock and real estate markets will follow with the latter being the slowest of all.



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Education Corner – The Credit Markets & Credit Crisis

The Genesis – As is now evident to everyone, the rapid rise in home prices was not rooted in a real increase in value. Home prices were rising by double digits in the late stages of the bubble even though wages were relatively flat. With their true purchasing power limited by wages, the only way home buyers could keep bidding up prices was by taking advantage of the flood of money from lenders who began handing out mortgages to anyone who wanted one. Appraisers hired by the mortgage brokers went along with the rapid run-up in prices as comparative sales research supported ever-rising prices. These lenders didn't have to worry that some borrowers couldn't pay the money back because they sold the loans off to Wall Street, which wrapped them up in a package with a big bow that said "Triple-A Rated." As long as house prices kept rising, no one bothered to count the skeletons in the closets.

Credit Default Swaps (CDS) – CDS are risk transfer transactions whereby, in exchange for a "premium", the seller agrees to make a payment to the buyer to protect the buyer from credit risk or loan defaults. The estimated gross market value of outstanding CDS globally for 2007 is estimated at approximately \$2 trillion. To most of us, "premiums" are what we pay for *insurance*, but the growth of the CDS market has been premised largely on light regulation under securities and insurance laws and supported by a view that CDS are subject to favorable taxation rules as "notional principal contracts" rather than as *insurance*. Because this was not deemed to be an "insurance" product, large issuers of CDS, such as AIG, did not need to set aside reserves to pay future claims like an insurance company. As millions of homeowners defaulted on loans, AIG was unable to cover the costs. Expected regulatory changes will result in CDS transactions being considered "insurance" for regulatory purposes, but the existing credit problems remain. The banks and investors holding mortgage backed investments are big losers, now that millions of homeowners are defaulting on loans.

The Crisis – At the moment, the conventional rules are out the window. The credit markets are not behaving normally, and the price of money is based on fear. Banks have stopped lending to each other because they're afraid the bank they lend to may be the next one to fail. Mortgage lending is in slightly better shape as long as you have a large down payment to insulate the lender from further declines in the value of your home. Currently, one in six homes in America is worth less than the amount owed on it. The money market ultimately sets the true "cost" of money just like the stock market sets the value of shares. Banks and investors with money to spare sell it in the credit markets; interest rates rise and fall as borrowers offer more or less interest to "buy" money. Just as supply and demand set price in any market, if there is a lot of money looking for investments rates go lower. If available money is scarce, rates go up. It remains to be seen how long credit will remain locked up. The Fed and the Treasury are flooding the system with cash, but it may take government-backed guarantees to give banks and investors confidence to start lending again.

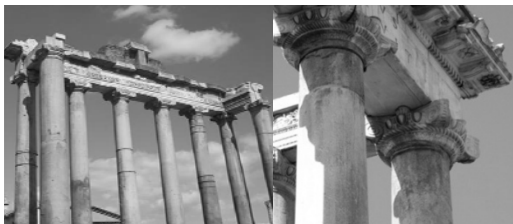
Bonds, Credit & Your Portfolio

During 2008, investors continued to seek more stable investments causing U.S. Treasury prices to rise and less credit worthy bonds to decline. This typifies the "flight to quality" that is seen during periods of stress. Short-term U.S. Treasuries were in such demand as to raise prices enough to the point where investors received almost zero return other than the principal, investors' primary objective.

Shifting Treasury Yield Curve



Nonetheless, timing interest rates and credit cycles is just as difficult as timing the stock market. As an example, just 3 months ago one of the market's primary concerns with bonds was inflation due to rising commodity prices. Today, it is deflation. Bond investors' risks are primarily inflation risk, default risk, interest rate risk, prepayment risk, and currency risk. As with equities, investors should maintain diversified bond portfolios with varying maturities and credit qualities. Bond prices fluctuate based on future cash flows much like stock prices, but the primary difference is that bond cash flows are clearly spelled out in legal documents where stock cash flows are



unknown and directly tied to a company's ability to generate profits. Most bonds outside of U.S. Treasuries have struggled of late, but a relaxing of fears in the credit markets could bring those values back quickly. Once default risks subside and the prospects for repayment improve, there are few other impediments to a recovery in bond prices. Indeed, it is a stabilization of the credit markets that the government is working so diligently to achieve knowing that the spillover to the equity markets should be a positive one. Until then, principal protection is key.



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Taurus Capital Management is here to guide you through these difficult times and to help you understand and maintain perspective on the markets. Market volatility has been challenging and unlike anything we have seen in many decades. If you have questions, please never hesitate to contact us. We always remember that you have entrusted us with your hard-earned savings and we work tirelessly to protect and grow your wealth with prudent and time-tested methods.

What Else Can I Do Besides Worry?

After the September 11 tragedy, President Bush told everyone to "go shopping." Americans have never had difficulty with that concept! However, considering that the primary economic issue at hand was created by a poor savings culture, now is the time for everyone to review and improve spending and credit habits. Americans love our toys and over the last few decades have borrowed ever increasing sums to purchase the "wants" as urgently as we purchased the "needs." To protect yourself, your home, and your family, now is the time to spend wisely. We all need to enjoy life and our various vices whether that be a morning coffee run or a new pair of shoes, but if you are finding that you are short on cash and high on debt, moderation is the keyword for the day.

Signs that your credit score may be in trouble – 1) You are turned down for a credit card, car loan, mortgage, or home equity loan; 2) your rates to borrow are higher than you expected; 3) You are maxing out your credit cards; or 4) You pay late or borrow from one credit card to pay another.

Things you can do to improve your credit score – 1) Pay down debt; 2) Use credit cards responsibly; 3) Pay your bills on time; 4) Review your credit report; and 5) Be careful with spending and be honest about which expenditures are "needed" versus "wanted."

We will get through this latest economic downturn like we always have, but a new generation is learning the merits of saving for a rainy day and the benefits of living with less debt on our shoulders. Always feel free to contact us with your questions, comments, and concerns.

Taurus Capital Management & the Community

We not only work here, we live here.

Taurus Capital Management will always take a responsible role to support organizations providing critical services to our community. Thus far during 2008, Taurus Capital Management has proudly made significant donations to the following organizations:

American Red Cross
Boy Scouts of America
Campfire USA
Children's Cancer Association
Deschutes Children's Foundation
Loaves and Fishes (Meals-on-Wheels)
Pacific Crest Community School
Portland Hope Meadows
Portland Youth Philharmonic
The Leukemia & Lymphoma Society
Ronald McDonald House Charities



RONALD MCDONALD
HOUSE CHARITIES
Oregon and Southwest Washington

LOAVES & FISHES CENTERS
The Meals-On-Wheels People



Thank you for being a valued client of Taurus Capital and for making such donations possible.

As always, earning your continued confidence and trust in Taurus Capital Management is the cornerstone of all we do. Please feel free to share this newsletter with anyone who may be interested. Referrals are always welcome and appreciated!

Gregory G. Saliba
Principal