



Baldwin Investment Management, LLC

OUR LAST THOUGHTS FOR 2008

We are concerned in the long run, 2011 and later, about the effects of the promised massive expenditure by the Obama administration to “jump start” the U.S. economy. We agree with the need for the stimulus and think that it must be of significant size to have any chance of success. Our worry is about probable inflationary aftermath of this program. The government including the Fed must be on guard in monitoring prices and eventually proactive in *taking back* the stimulus “punchbowl” after it becomes apparent that the American economy has stabilized. Unfortunately, history does not “paint a picture” that would suggest such discipline. The result of this lack of constraint could be a period of “stagflation”, stagnant economic growth combined with inflation – so what to do?

Inflation is an “acid” which over time destroys the value of any long term fixed income security. In order to adequately respond to an inflationary threat, the Fed will eventually resurrect the monetary tools of the Volcker era and dramatically raise interest rates. This will at some point stop inflation – but in the meantime, significantly reduce the value of long term bonds. So in fixed income markets, the strategy should be of short duration to take advantage of the increasing interest rate levels. Bond quality should also be of importance, because high interest rates (i.e. expensive money) hurt most borrowers.

In the equity markets, stocks of commodity producers such as natural gas companies, iron ore producers, etc., should be a focus of attention as the end commodity will no doubt, go up in price. Users of commodities such as car companies, airlines, etc., will be under pressure as the cost of goods manufactured increases. Companies which are not heavy users of commodities as raw materials like service companies, information technology, etc., will not be as heavily influenced. While we think that the stocks of commodity producing companies will be increasingly attractive once the economic recovery begins, there is sometimes a “disconnect” between the price of the stocks and the value of the underlying commodity. We saw this most recently in the oil markets when the price of oil rocketed to \$147/bbl, but the stocks of most oil and gas companies never reflected that commodity pricing level. We believe that some direct

exposure to commodities should be part of a well diversified portfolio. The particular vehicle to be used to accomplish this we have not yet chosen. This is a task for the near future.

President-elect Obama has declared his intent on making our earth “greener”; so corporations with interest in solar power, wind power, nuclear energy and even natural gas should be on a “favored” list. Consumer discretionary equities have been leaders in the past and consumerism in America will never die, but it will be “toned down” for the foreseeable future. The very rich (there will still be some) will indulge, but savings will go up and consumption down for most Americans.

Regulation will be back in fashion. The “Wild West” of finance is dead. Equities related to financial companies will reflect tightening regulation. Profitability on Wall Street will be lower because costs will be up (regulation) and leverage will be down (from 30 to 1 down to 10 to 1). Mr. Obama has also declared that health care in America is due for an overhaul and he is the mechanic to accomplish the task. True discovery (i.e. innovative new products) will still be rewarded – but most of the rest of healthcare will probably be constrained regarding profits, which will be reflected in healthcare stocks going forward.

If stagflation does develop in the U.S., then other countries around the world might well be more attractive for equity investment. America has no longer a fast growing economy and will be burdened in the future with increased regulation, higher costs of doing business and inflation. Numerous international markets are not so hampered and with burgeoning middle classes will outperform. We suspect that the world is going through a transition. For decades, the U.S. has been the economic epicenter. Coming out of this financial debacle, America will no longer be alone at the top. Economic power has already started to flow to China, India, the Middle East and Southeast Asia. This is not to say that the U.S. will become insignificant economically. Simply, we believe that other nations in the world which have embraced capitalism have taken on and will continue taking on new levels of importance in the world. Thus, investors should already have and should expand their international investments. This would include American multinationals which are doing a majority of their business overseas and corporations headquartered overseas and doing business ex-USA.

No doubt that investor confidence has been sorely shaken after this downdraft in the markets. Many investors are wondering if the public markets are any longer “safe”. Also, can one be a long term investor or does one have to trade much more actively to navigate the currents? Rules and regulation which controlled some aggressive trading, like the “uptick rule”, were rescinded and some other rules which were put into place for the best of reasons, like the accounting rule “mark to market”, have been proven to be counterproductive due to manipulation by traders seeking an advantage. Re-regulation is to be the new order of the day with the Obama administration. While philosophically, we are against most forms of government interference in the marketplace, unfortunately, humans have again demonstrated their inability to “play nice in the sandbox with others”. So, the market will probably welcome some new rules to control bad behavior. If an investor ultimately believes in the American free market, capitalist system then as a long term investor he/she will have success in the stock market because this is still the best way to tap into the growth of an industry and a particular company. Traders

who create a lot of market noise and a lot of volatility have to a large extent been eviscerated in this market meltdown because of their excessive use of leverage to “hype” returns. Long term, unleveraged investors have certainly had an uncomfortable ride recently. But if one is not forced to sell and the companies held as investments are well placed, then current market levels are offering the long term investor an opportunity to buy assets more cheaply than before. This is the philosophy espoused by Benjamin Graham and Warren Buffet with which we agree. We believe in being a long term investor, not a trader. This does not mean that we will necessarily hold an investment forever (our average portfolio turnover approximates 35% per year). But we will not turn a portfolio 100% per year.

Value abounds in the stock markets from almost any and every commonly used metric. Importantly, the markets seem to be holding the November lows even in the face of some terrible economic news. This is consequential because it would suggest that investors have already priced into the markets their view of a bad recession. The first and second quarters of 2009 will not be pretty economically and the Obama stimulus will not have any discernible effect until the second half of next year. So if the U.S. stock markets can continue to form a base with bad earnings staring at them, then the bottom has been made. Many foreign markets are in a similar position.

With regard to fixed income, corporate and municipal bonds are very cheap. The new market “bubble” is in U.S. Treasury securities, which investors have been bidding up because of fear. Once people recognize that the world is not going to come to an end, as we believe, then there will be a huge rush to invest first into corporate and municipal bonds and then into various equity markets around the world. There is a “sea” of money awaiting “the all clear” to invest. Once the rush is on, the door through which everyone will want to go will get real small, real fast and prices will rise impressively.

FROM ANOTHER QUARTER.....

Will the financial system melt down, or is this merely the greatest down cycle we’ve ever seen? My answer is simple: we have no choice but to assume that this isn’t the end, but just another cycle to take advantage of. I must admit it: I say that primarily because it is the only viable position.

Here are my reasons:

- It’s impossible to assign a high enough probability to the meltdown scenario to justify acting on it.
- Even if you did, there isn’t much you could do about it. **
- The things you might do if convinced of a meltdown would turn out to be disastrous if the meltdown didn’t occur.
- Most of the time, the end of the world doesn’t happen. The rumored collapses due to Black Monday in 1987 and Long-Term Capital Management in 1998 turned out to be just that.

**-- Money has to be someplace; where would you put yours? If you put it in T-bills, what purchasing power would be accorded the dollars in which they're denominated? If the government's finances collapsed, what good would your dollars be, anyway? What depository wouldn't be in danger? If you and many others decided to put billions into gold, what price would you have to pay for it? Where would you store it, and how would you pay for the truck to move it? How would you spend it to buy the things you need? What would people pay you for your gold, and what would they pay you with? And what if you bought credit insurance on all of your holdings: who would be able to make good on your claims? No, I don't see any viable way to plan for the end of the world. I don't know any more than anyone else about its probability, but I see no use in panicking. I think the outlook has to be viewed as binary: will the world end or won't it? If you can't say yes, you have to say no and act accordingly. In particular, saying it will end would lead to inaction, while saying it's not going to will permit us to do the things that always have worked in the past. We will invest on the assumption that it will go on, that companies will make money, that they'll have value, and that buying claims on them at low prices will work in the long run. What alternative is there? ¹

¹ Harold Marks, Chairman Oaktree Financial

PREDICTIONS FOR 2008

1. Late in 2008, the Fed will begin to raise interest rates
2. The dollar will appreciate in value vs. the Euro and Yen
3. Housing will stabilize in the second half of 2008
4. Financial stocks will outperform in 2008
5. There will be Middle East progress in Palestine and in Iraq
6. Oil prices will come down
7. Inflation will be a little worrisome in the first half of 2008;
8. Hillary Clinton will not be elected President; and Michael Bloomberg will run if the Republican field is "muddled" coming out of South Carolina
9. International equity markets will continue to distance themselves from U.S. markets
10. The U.S. stock market will do better in 2008 than it did in 2007

HOW DID WE DO?

WRONG – The Fed aggressively cut rates

RIGHT/WRONG – The dollar became the asset of choice for investors, except against the Yen, which operated in its own “hedge fund intoxicated world”

WRONG – Some Faint signs of healing

WRONG – Only got worse, if that’s possible

RIGHT – Unfortunately in 2008 no one cared

RIGHT – In spite of all the volatility; a big help now

RIGHT – Not an issue; also a big help

RIGHT – We’ll see how Mr. Obama does

WRONG – Hedge funds forced liquidations turned this upside down

WRONG – Quite obviously!!!!

PREDICTIONS FOR 2009

- 1) Stock markets around the world will do better in 2009 than in 2008
- 2) Oil prices will rise
- 3) Housing will stabilize in 2009
- 4) The U.S. Treasury market will decline in price
- 5) Corporate and municipal bond prices will go up
- 6) The Baltic Dryship Index will go up, reflecting world growth
- 7) Inflation will not be an issue in 2009 – but will look like it will become an issue for 2010
- 8) China will assume a more important geopolitical/economic role
- 9) Alternative investment vehicles (i.e. private equity, hedge funds) will lose investors to mainstream investments
- 10) Russia will continue on its path of becoming more insular

A FINAL THOUGHT



The opinions expressed in this Commentary are those of Baldwin Investment Management, LLC. These views are subject to change at any time based on market and other conditions, and no forecasts can be guaranteed.

The reported numbers enclosed are derived from sources believed to be reliable. However, we cannot guarantee their accuracy. Past performance does not guarantee future results.

A list of our Proxy voting procedures is available upon request.

A current copy of our ADV Part II & Privacy Policy is available upon request or at www.baldwinim.com/disclosure.htm

12/31/08