



Portola Group Investment Commentary

February 13, 2009

After recent person-to-person conversations about our outlook and strategy, we thought it might be useful to put down the thoughts on paper so that all clients are up to date on our thinking.

The current Crisis has roots going back decades, but the decay accelerated exponentially in the last 5 years as financial institutions around the world lost their collective heads and our regulators were shoved aside, looked the other way, were deceived or were unable to keep up with the breadth and magnitude of the events or a combination of all the aforementioned.

3 Phases-The Crime Begins

We look at what transpired in three phases. The first is the biggest “white-collar” crime in modern history. Our financial system figured out how to tap the collective savings of the world, leverage it up (borrowed money) and then take a handsome fee. It was a “perpetual motion machine”. Everyone marketed the risk of the transactions to people and institutions without faces hoping that the music would never stop, or at least not stop until they collectively “got theirs”.

Second Phase Begins-The Cover Up

The music stopped in late 2007, and the second phase began to take shape. We refer to this phase as the biggest cover-up in modern history. We have all been led to believe that there are regulations and severe penalties for corporations submitting false filings with the SEC about the state of company affairs. Despite that understanding, we find it hard to countenance that all of the financial institutions reports since then have been accurate and complete. Indeed, a skeptic would say that many of them were terribly misleading if not downright false. We were told that everything was just fine.

It was not. In a series of events leading up to an early October implosion, we learned– despite the cover-up–that all was not well. Seriously not well. After the

failure of the first vote on the TARP rescue plan, individuals and institutions submitted redemption requests to hedge and private equity funds on September 30th.

The Selling Begins

As these requests were received, massive waves of indiscriminate selling occurred in the first eight trading days of October. The public was led to believe that the problems on Wall Street were not about Main Street, but the severe declines of early October showed the problems were systemic, and more waves of redemptions ensued. This time the redemptions were for 401k plans, individuals and mutual funds.

Hedge and private equity funds tried to amplify their returns by borrowing up to 5 times the amount of actual capital for which they had been entrusted. Financial firms were also levered up to 40 times their capital base. Many formerly super-rich were additionally leveraged up to their eyeballs. Thus, the redemptions, combined with the demands for borrowed money caused funds, institutions and individuals to do even more selling. It was, in effect, a gigantic margin call as the unraveling of the grotesque amount of debt ensued. Under such circumstances, anything that can be sold will be sold. The better the company, the greater the liquidity, the more the sell orders would seek those targets.

Broadway Play

We have told people that our job is like the Broadway critic who watches the same play over and over again. It always starts when we are all going to be poor, and always ends when we are all going to be rich. The number of actors and acts are always different, but it is the same script every time.

This time, the playhouse turned out to be built over a sinkhole. As it became apparent that massive amounts of debt had been used to speculate, we metaphorically and collectively fell through the floorboards of the playhouse into the basement. The markets did not respect the style, location or time frame of investors. Everything was for sale.

Third Phase-The Recovery

While the government and Wall Street continue to keep us in the dark about the true state of affairs, we now have a good idea of the magnitude of the problem. Assume it is \$6-10 trillion. It would have been \$1 trillion fifteen months ago if the government had told the truth, but they did not. In any event, prior to this debacle, the U.S. Gross Domestic Product was in the \$14 trillion range. For the major countries of the world, the collective GDP was about \$50 trillion. While we should all be outraged at having to cover a \$6-10 trillion hole in our pocket, the reality is that our economy and those of the rest of the world are big enough to handle it. We propose a more rational method: provide Federal guarantees over a specific period of time, and then pay down those guarantees out of our economic earnings over say the next ten years.

The government has not been taking that approach. The government has been trying to use actual savings to make up for the air pocket in our finances. The trouble with trying to fix it in a short period of time with savings, is that the savings are primarily coming from overseas. Since the other governments want to bolster their own institutions and create their own stimulus packages, the unthinkable was asked recently: if there were enough savings in the world to do what had been proposed.

Perhaps because the answer to the question is no, governments are coming to their senses and are taking actions that will allow us to work our way out of this crisis over time.

The Fork In The Road

As we see it, there are two basic outcomes. One is that the governments will fail. If so, we will be back in the Stone Age bartering for our daily needs. While this sounds facetious, it evidently did occur in the '30s in different parts of the United States as cash ran out. Several communities resorted to creating their own form of money.

We assign a very low probability of this first outcome. Since we will be making these guarantees with the collective savings and economic power of the entire world—let alone the ability to create money out of thin air with printing presses—it is hard to imagine that the guarantees would not work. We have always felt that we would see inflation before Depression because of our ability to print money.

The second outcome is that it works. We believe that the odds are extremely high that this second outcome prevails. There are already signs that the global

economy is beginning to stir, despite all of the negative headlines. Unemployment, for example, rises well after the leading components of the economy start to change for the better.

Given that the resources committed to turning things around are unprecedented in their size, the only question is when the recovery will happen, not if. The magnitude of the recovery could be very substantial given the swift and painful decline that began in the fourth quarter of last year as well as the unprecedented amount of wealth being thrown at the problem.

We believe that the economy will come back stronger and sooner than expected. We believe we will see an explosive move to the upside as investors scramble to get back in and short-sellers try to get out of the way.

Recovery At A Cost

There will likely be a heavy price to pay for our rescue. Taxes are what government spends, not what they raise. The difference between the two eventually shows up in the form of inflation. Given that we are running huge annual deficits as well as having an accumulated debt of as much as \$12 trillion already, it is hard not to envision substantially higher taxes or inflation or both. We are enjoying historically low inflation and interest rates at the moment, but the health of our nation's finances will turn quickly and become much worse, if either or both of these scenarios move in the other direction.

From an investment standpoint, only two choices exist, fixed income and equities. Fixed income can take the form of money market instruments, money market funds, Treasury bills, Treasury notes, Treasury bonds, etc. Equities are domestic stocks, foreign stocks, real estate, private companies, commodities, alternative assets (hedge funds, private equity, and venture capital). The coming reflation effort and future recovery will be very favorable to certain types of equities and unleveraged real estate. It will be devastating to fixed income. Therefore, for the moment, we are positioned to take advantage of the recovery primarily through common stocks. The common stocks emphasize growth companies as well as those that are heavily oriented to resources and transportation. We are also targeting a relatively heavy allocation to gold. As this process plays out we must keep in mind that these changes contain elements that are more secular in nature as opposed to cyclical; this critical distinction implies a longer runway for these trends to completely develop. While the necessary pieces are falling into place, the timing remains elusive putting a premium on guidance and patience.

We saw this scenario play out in the '70s. President Nixon took us off of the gold standard, which had fixed one ounce of gold to \$35. We then went on the

“Responsibility Standard”, promising that we would not print too much money. Gold peaked in the \$800s, mortgage rates went to 21%, as well as other very painful events. Until Chairman Volcker put an end to that inflationary phase, the allocation outlined above was appropriate.

In the last few weeks, we clearly are abandoning that Responsibility Standard. We are committing massive debt loads to ourselves, our children and our grandchildren. Our trading partners are unhappy about it, but we are all joined at the hip for the foreseeable future.

Our sincere hope is that we and our elected officials can get through this situation by doing the right things. Regardless, we will remain proactive and execute appropriate investment strategies.