

January 9, 2009

Dear Friend,

2008 began with a liquidity crisis that seemed to impact only investment banks, brokerage firms and hedge funds. But in the end, the problems on Wall Street set off a chain reaction that affected every asset class in nearly every country in the world. The idea that non-U.S. economies would continue to prosper while the U.S. went into recession was dispelled as a myth. The world is now truly global both for better and for worse.

In 2008 our Diversified Equity Composite declined by 29.5% compared with the S&P 500's 37.8% decline. Our Concentrated Equity Composite declined by 33.2%.¹

As of the end of the third quarter, the S&P had declined by what now seems a relatively moderate 19.2%; at that time, both of our equity composites were down 13.3%. Up till then we had achieved our outperformance by avoiding financial stocks (we owned none) and investing defensively in consumer non-cyclicals and health care. But once the U.S. government practically nationalized Fannie Mae and Freddie Mac, and at the same time allowed Lehman Brothers to go bankrupt, the bond market collapsed. Yields on high-quality corporate bonds, low-quality corporate bonds and tradable bank loans all shot up as investors rushed to dump them. This, in turn, created havoc in the equity markets. Defensive companies that used to trade at 18x earnings now trade only at 14x earnings. An out-of-favor company that recently disappointed the street and might have traded as low as 13x earnings might now trade as low as 10x earnings.

¹ Preliminary performance figures are unaudited. Past performance may not be indicative of future results and every investment program has the potential for loss as well as profit. The diversified equity composite is the dollar-weighted linked monthly return of those accounts sharing the objective of a diversified equity portfolio that are greater than \$250,000 in size. The concentrated equity composite is the dollar-weighted linked monthly return of those accounts sharing the objective of a concentrated equity portfolio that are greater than \$250,000 in size. Accounts are added to the composite on the first day of the month following our first 30 days of managing the account and must be in the composite for a full calendar quarter before inclusion. Portfolios are excluded as of the last full calendar month under management or at such prior date as Integre Advisors receives notice of termination. Individual account results will vary from that of the composite based on fee structures, investment restrictions, the timing of contributions and withdrawals and other factors. Comparisons to the S&P 500 Total Return are for informational purposes only, as the composites may hold securities not in the S&P 500 and may have more or less volatility and risk than an investment in the S&P 500.

We are currently living through the mirror image of the internet days when practically the only articles you could read, the only conversations you could have, were about people making fortunes in dot-coms. Now it's all about how much money people have lost. As legendary investor John Templeton once said, "People are always asking me where the outlook is good, but that's the wrong question. The right question is where is the outlook most miserable?"

Currently we are finding our best opportunities in the small-cap sector. The reasons for this are several. First, there has been a surfeit of non-fundamental selling in small-caps due to extensive mutual fund and hedge fund redemptions. Exaggerating the impact of this selling pressure is the fact that these companies are so small that no managers "have to" own them (unlike blue-chip companies which are in the major stock indices.) In addition, and rather perversely in our opinion, the lower these small-cap companies' share prices go, the less attractive they are to the typical manager who likely has market-cap restrictions. What these restrictions mean, in effect, is that the same company that managers were content to buy at \$20-a-share is no longer a buy at \$5-a-share despite the fact that the price is now *seventy five percent less*. Our only restriction, and it is a self-imposed one, is that we will not invest in a company unless our position represents no more than 20% of the average volume in the stock over a four-day period. This is to ensure that we do not significantly impact the price of a stock when either buying or selling it. The opportunities available in small-caps today remind me of the opportunities we saw, and took advantage of, in corporate spin-offs in the early part of this decade.

None of this is to say that the U.S. economy is not doing terribly right now. It is. The borrowing rates for all but the most blue-chip corporations are in the double-digits, prohibitively expensive. Home prices are declining precipitously. And consumer spending which was already weak at the beginning of 2008 took another leg down in October with the collapse of the stock market. In this relentlessly negative environment it is easy to forget that one does not need a complete recovery to make the stock market rise.

As we have always said, the stock market moves from fear to greed and overshoots in both directions. At this particular moment, poised between the end of a highly unpopular presidency and the start of a new one that at the very least holds the promise of basic competency if not more, a little bit of greed may be beginning to work its way back into the system. In recent weeks, credit markets have started to rally. With this momentum plus new Obama policies that may seek to directly grant credit to homeowners with whom this crisis began, the vicious cycle that felled the stock market may come to a halt.

Ten years ago the economy's prospects were very bright. In fact, we were at the dawn of a new era of technologically driven productivity. But the S&P 500's 1999 valuation of 26x earnings was too high. Currently the economy stinks, but the valuation is only half of what it used to be. Over time, it is low valuations and not "bright prospects" that have been the best indicator of stock market returns over a ten-year period. Low valuations are a certainty that might improve, while vibrant economic activity has the potential to fade. We believe that the current combination of low valuations and economic pessimism have created the best opportunities for future gains that we have seen in years.

With all best wishes for a healthy, happy and prosperous new year.

Sincerely,

Manny Weintraub, CFA
Managing Director