



September 23, 2008

The extraordinary events of recent days prompt us to send our quarterly letter a bit early. In what may prove to be one of our more controversial opinion pieces, we will wade into the sensitive subject of government intervention in a “free market” economy. In our opinion, capitalism does not mean anarchy. A strong and functioning regulatory system is a vital component to the capital markets. There was a traffic jam of epic proportions last week on Wall Street. The credit markets stopped functioning, as firms were reluctant to commit capital in an environment where their own liquidity was under attack. Failure in the credit markets caused companies in virtually all industries to lose access to the funds they need for daily operations. The system crashed, and we needed a fleet of tow trucks and ambulances in a hurry. We believe the federal government was right to step in to restore confidence and liquidity in the markets.

The federal government takeover of mortgage giants Freddie Mac and Fannie Mae, and the enormous insurance company AIG, are stunning developments. Lehman Brothers filed for bankruptcy, and Merrill Lynch sought refuge in the acquisitive arms of Bank of America. Over the weekend, Washington moved quickly to shore up the financial system with a proposed \$700 billion facility to remove troubled assets from corporate balance sheets. Questions linger regarding the fate of prominent firms as this massive restructuring unfolds. These are huge events, and it seems every trading day is buffeted by news of more mergers, bankruptcies and government bailouts.

At the risk of pushing an analogy too far, we view capitalism as the ability to get in our own cars and go where we want. However, there are stop lights, street signs and speed limits along the way, as well as a police force to issue traffic tickets to people who disobey the rules of the road. Cars are manufactured with bumpers, air bags, seat belts, anti-locking brake systems and other safety features. Drivers are required to maintain a valid license to show that they are fit to drive. If not for these precautions, it would be a chaotic and hazardous endeavor to simply get across town. The goal is to allow personal freedom to choose where we want to go, while helping the highest possible number of people to arrive safely at their destinations.

People will make mistakes. The history of civilization is peppered with financial failures and periodic panics, including our country’s last mess during the 1980s with failed savings & loans. It was a familiar scenario, with a housing downturn leading to defaults on mortgages and lost confidence in the financial system. The federal government finally stepped in with the controversial Resolution Trust Corporation (RTC) to make depositors whole and to systematically unwind the troubled loans from the system. Between 1989 and 1995, the RTC resolved \$394 billion worth of assets from failed thrifts. Along with that bailout came revised rules and regulations for the financial services industry, including a higher capital balance requirement for banks that arguably put them in a better position to weather the current wave of bad loans. While government intervention

is unfortunate, it appears necessary in the current situation, as an orderly unwinding of troubled assets is likely to provide better results than a frantic stampede to the exits.

It is a challenge to keep the rules current with changes in the global marketplace. Since the savings & loan crisis of the 1980s, there has been increasing overlap in the activities of banks, brokerage firms and insurance companies, while each of these areas continues to be separately regulated. Today, people routinely use money market funds for their deposits, a pool of savings that has grown to roughly \$3.4 trillion and serves as the primary buyer of commercial paper issued by a variety of corporations to finance their daily activities. A largely unregulated pool of capital, hedge funds have grown roughly tenfold this decade, with approximately 9,000 hedge funds controlling over \$2 trillion in capital. Markets around the globe are more interconnected today, as firms are able to structure assets of all kinds and buy or sell them with trading partners from other countries. Perhaps one of the best outcomes from this recent crisis will be an overhaul of our regulatory functions to make them better suited to supervise the activities of our financial services industry. We believe all drivers on the road should be abiding by a similar set of rules and oversight.

Enclosed is an article that you might find interesting and encouraging. The publication Pensions & Investments surveyed investment advisors' views, including the opinion of West Oak Capital, regarding the government takeover of Freddie Mac and Fannie Mae. Those surveyed generally agree that the move was necessary and a positive step toward recovery in the housing marketplace, which is central to getting the overall economy back on a positive track. Regardless of anyone's political or economic views, this is a remarkable and historic period for our financial services industry.

Please call if there are any thoughts or questions you would like to discuss. The housing market, oil prices, hurricanes, the Presidential elections...there are plenty of interesting topics in the news, and we always welcome the opportunity to talk with you.

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