



Value, Performance, & Service

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2007 Annual Letter to Clients

We are pleased to present the following reports as of December 31, 2007, which summarize your investment account(s) with Aldebaran Capital, LLC.

In 2007, the stock market entered the year paying very little heed towards risk and ended the year in volatile tumult. Despite being dealt a series of adverse events as the year progressed, the broad market averages managed to finish the year with modest positive returns. For the year, the S&P 500 index advanced 5.5% with dividends reinvested.

As you know, we construct portfolios that differ significantly from the broad market, and being “non-correlated” with the market is one factor that has contributed to our outperforming the market indexes over the long term. Being dissimilar to the market also means that we are sometimes out of sync with short-term market trends, and alas in 2007, we lagged the market’s return. The performance report page of this booklet details your portfolio’s return for 2007 and since inception with our firm, and compares those numbers to a variety of market indexes.

As we mail these reports to you, a poor start to the market in 2008 has more than erased 2007’s full year return and appears to be on the verge of one of those nasty periods that the markets will occasionally deal to investors (we will have more to say about this later). As we head into 2008, we feel that our portfolios are positioned to weather the storm, buffered by a hefty cash position. In fact, it is in periods like these that we look to take advantage of the market’s pessimistic mood by establishing new investment positions that we expect will pay off over the next several years.

Risk comes out of hibernation

As 2007 began, the stock market had just completed a steady run upward during the second half of 2006. A chart of the market over those last six months of 2006 plots as an effortless line streaking higher, while during that period market volatility measured by the VIX index, was hovering at a 20 year low. *At the time it seemed like investors had abandoned any thought that stocks could go down.*

The lack of concern for risk could be seen in many areas of the markets. Money could be borrowed easily and interest rates were low. Private equity funds could borrow the funds to buy companies worth nearly \$50 billion. In 2006, the high-yield or junk bond market experienced a record low default rate of 0.8%, which is in sharp contrast to the long-term average junk bond default of rate of 5%. REITs (real estate investment trusts) had been on a tear for several years and had risen 34% in 2006. The residential real estate market had made speculators a lot of money and homeowners were feeling wealthier on the perceived value of their homes. The S&P 500 rose 15.8% in 2006.

The calm market was jolted in late February 2007 with the initial reports of trouble in the subprime mortgage market. However, after an abrupt drop in stock prices, the market quickly shrugged-off the news and mounted another strong advance through the spring. It wasn’t until July and the

announcement that two Bear Stearns' hedge funds had collapsed (due to leveraged bets on subprime securities) that the markets began to suspect a larger problem.

Seemingly overnight, the liquidity in the credit markets shut down as risk arrived back on the scene. Throughout the second half of 2007, investors in financial stocks suffered; as a parade of investment firms and banks reported massive multi-billion dollar losses due to write-downs in the value of their holdings in subprime mortgage securities and collateralized debt obligations (CDOs).

The Subprime Loan Debacle

Subprime mortgages are mortgage loans made to homebuyers with less-than-stellar credit profiles. At the peak of the housing bubble in 2005 and 2006, some mortgage brokers were lending money with little concern as to how it might get paid back. New home loans and refinanced loans were made without documents that verified the borrower's credit worthiness. These no-doc loans were known by a more descriptive term - "liar loans." The mortgage industry also seduced homebuyers with low "teaser rates" on adjustable mortgages.

Around the peak of the residential real estate bubble in 2005 and 2006, as is often the case in any market bubble, a herd mentality takes over and people and institutions will often do silly things – things they might not normally do when thinking more rationally. The business done at the peak depended on home purchases made by marginal buyers with risky loans. In the hot real estate markets, homebuilders were making record profits and building record numbers of new homes, mortgage brokers were making big money extending newfangled loans to people with dubious credit histories, Wall Street was packaging up the subprime loans in securitizations, selling them and booking huge fees and profits, and the ratings agencies (Moody's and Standard and Poor's) were earning large profits by reviewing and rating all the securitized mortgages pumped out by the investment banks. Few gave any thought to questioning the wisdom of some of this behavior – there was just too much money to be made. The other participant that kept the wheels in motion was the homebuyer. In the devastating aftermath, some observers (including Congress) are questioning whether all homebuyers understood the onerous terms of their mortgage loans or were bamboozled by aggressive brokers and fantasy loan structures.

By mid-year 2007 the air was seeping out of the real estate bubble, due to a combination of home prices that had risen too high, too fast and subprime mortgage loans that had begun to sour. Many of these businesses and participants who got caught in the bubble are now in various stages of disarray, with further damage still on the horizon. Some two million homeowners hold roughly \$600 billion of subprime adjustable-rate mortgage loans, that are due to reset at higher amounts during the next eight months. Many may see their monthly mortgage payment climb 35% or more, and find themselves unable to make the payments on the loans. *The legacy of the subprime-lending spree will be record high foreclosure rates for the foreseeable future.*

The homebuilding industry benefited tremendously from easy credit, and built/sold a record number of new homes. The industry now finds itself in a tenuous position with heavy debt loads and reduced cash flows to service that debt. Their main assets are land, whose value has deteriorated. Some homebuilders may go bankrupt or restructure, but the industry will survive; it is just going to take time to work off the excess inventory.

Wall Street (of course) cashed in big on the subprime mortgage market by packaging up pools of mortgages into securities in a process called "securitization". Investment banks earned *billions in fees* creating these securities and selling them to investors like hedge funds, mutual funds, and institutions. A related product called a collateralized debt obligation (CDO) might contain mortgage securities of various quality and other debt issues, like leveraged loans and derivatives. Sometimes these securitizations were insured by one of the large bond insurance firms like MBIA, or AMBAC. Based on the perceived quality of the securities in the pool and other factors like insurance, the rating agencies would often assign high ratings on the securitizations and CDOs. Hedge funds would borrow large amounts of money to magnify the potential returns on their holdings.

However, the failure of those two Bear Stearns hedge funds awakened the market to the fact that many subprime mortgages were starting to default. The shockwave sent through the debt markets led to a “credit crunch” virtually overnight. Holders of these securities could not get accurate prices to buy or sell them and liquidity in the mortgage and CDO market vanished. When buyers did step in, it was only at firesale prices leading to huge losses for investors. The investment banks who created securitizations and CDOs, were themselves large holders of these securities. Accounting regulations require these firms to mark their holdings at market prices and record their losses in earnings each quarter. Thus began the parade of multi-billion losses announced by Citigroup, Merrill Lynch, UBS, and Bear Stearns, to name a few.

One thing that you can say this time around is that, in contrast to past debacles such as Enron and the tech stock IPOs of 1999, Wall Street was unable to unload the damaged goods on the public before they blew up. This time they got caught with their own hand in the cookie jar and are paying for it with huge losses and weakened balance sheets. The *arrogance of the investment banks* can be summarized by a comment made by Citigroup’s Chuck Prince last July who said, “When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you’ve got to get up and dance. We’re still dancing.” This is a classic example of the “*institutional imperative*” that Warren Buffett has discussed - “*In their lemming-like behavior, the actions of institutions will continue to cluster around the herd, even though the evidence is that the particular activity will result in a poor outcome.*”

In the aftermath, many large businesses lay damaged. An index of homebuilding stocks has lost half of its value from its peak. Many mortgage lenders went out of business, and one of the largest, Countrywide had to be rescued by Bank America. The large investment banks have seen their valuations cut in half and are raising capital for foreign sources to shore up their capital. The bond insurers who strayed from a steady business of insuring municipal bonds, to insuring high risk CDOs are desperately seeking new capital to stay in business. In fact, Buffett’s Berkshire Hathaway announced that it would get into the municipal bond insurance business to fill the void, demonstrating that “*he who has the capital in times of distress, benefits.*”

At present there is concern that credit issues will spill over to the consumer and raise the levels of default in credit card and auto loans. Many economists are predicting we are on the verge of an economic recession. Thus, it is no wonder that many on Wall Street are predicting that “distressed investing” will be one of the more successful investment strategies in 2008.

Bond market veteran Bill Gross of PIMCO notes that current projections are that ultimately there will be \$250 billion in subprime mortgage related losses. Gross adds to that figure another \$250 billion in the derivatives market in credit default swaps. Considering the ripple effect of the leverage that has built up in the financial system during the easy credit days, it is no wonder that noted value investor Jeremy Grantham of GMO, predicted that before this is all over, a major bank will fail.

Seminal Events of 2007

Alternative investing: Institutional investors (pension plans) have been piling money into alternative investments under the belief that they can provide better returns than the stock market. These are investment vehicles like hedge funds and private equity funds, both of which often use copious amounts of borrowed money, in an effort to enhance their returns. That leverage can cause problems in a difficult market environment

Last year Blackstone Group (one of the largest private equity firms) and Fortress Group (one of the largest hedge funds) both sold shares to the public in an IPO. Both stocks sank almost immediately after their offering dates and remain sharply down from their offering prices. For the buyers who are lured into purchasing these issues, the *lesson* has been taught many times before – *when the principals are selling their stock to you, why would you buy?*

In our opinion these IPOs marked the top for alternative investments and *the returns investors will earn going forward will be largely disappointing.*

Commercial real estate: When Sam Zell sold his signature REIT, Equity Office Properties, in February of 2007 for nearly \$40 billion, how could an observer's conclusion be anything other than it was a call by one of history's savviest real estate investor that commercial real estate prices were near their peak. Prior to this sale, real estate markets were displaying all the signs of a bubble peak, with stories of hedge funds fighting over office space in London at \$300 rent per square foot. The buyer of Equity Office was the Blackstone Group, and at the time, it was the largest private equity buyout in history. And yes, with the benefit of some hindsight, *the sale essentially marked the top of the REIT market.*

Sovereign Wealth Funds: Some new players made their presence known in the investment world in a brash way in 2007. So-called sovereign wealth funds are huge investment funds accumulated by the governments of foreign countries. China has a \$200 billion fund largely earned from the surplus it collects on trade with the US which, on the other side is our growing trade deficit. The largest is the \$875 billion Abu Dhabi fund in the United Arab Emirates, earned from petrodollars on oil exports as oil prices that have more than tripled in recent years.

The trade deficits that the US runs with many of its trading partners has largely led to the sharp drop in the US dollar versus the value of other foreign currencies. The sinking dollar has made US assets cheap to foreign investors with buying power in stronger currencies. Recently, many of the US investment banks that suffered losses in subprime mortgages, have turned to these sovereign funds for strategic investments to shore up their capital bases. We would expect the foreign buying spree of US assets to continue. And, of course, there is already political concern that the US is losing ownership of domestic assets.

Miscellaneous

The credit crunch has also caused liquidity problems in short-term securities called commercial paper. Money market funds are big investors in high quality commercial paper. Since this market was not functioning smoothly, **as a precautionary measure back in August, we moved the cash balance in your money market fund into the Schwab US Treasury money fund which is composed of short-term US Treasury securities.** We want to stress that this decision was not made out of panic or anything of the sort. It would be extremely unusual for any regular money market fund to "break the buck", or in other words lose money. That being said, given the current conditions, we felt it prudent that your cash holdings were invested in the safety and liquidity of Treasury securities for the time being.

Conclusion / Outlook

We understand the uncomfortable feelings that most investors experience when the value of their holdings decrease during these occasional downdrafts in the market. We don't particularly enjoy the punches a fearful market can deliver either...but we are keenly aware that it is in these depressive periods that some companies become available for purchase at bargain prices. It has been awhile since the markets have gone through a tough stretch, but as Warren Buffett once cleverly said, "If you are going to be eating hamburgers for the next 5 years, what do you want the price of beef to do?" Thus, it is important to keep in mind that *as stock prices drop, we are able to put money to work at values that will provide higher long-term returns.*

We also know that with technology today, it is simple enough to pull up your holdings and watch the play-by-play of a market rout, if one so chooses. We would encourage you to pay little attention to the daily movements of your stocks and remember the wise counsel that *"you make your best investments in a bear market, you just don't know it at the time."*

In general, we feel your portfolio is well positioned to weather a market storm. We have a significant allocation of cash, along with some arbitrage investments that will convert into cash in the coming months. In addition, we feel that our key holdings are priced at levels where our downside risk is much less than the overall market.

And speaking of Warren Buffett, Berkshire Hathaway is one of our largest holdings. This diversified AAA rated conglomerate provides a solid foundation to client portfolios. Warren Buffett has built a "financial ark" that is positioned, not only to weather difficult market conditions, but to thrive in them. With a rock solid balance sheet and nearly \$50 billion in cash, Buffett is poised to make some spectacular long-term purchases as the prices of great businesses experience a temporary drop in value. He recently quipped in a Wall Street Journal article, "*I can spend money faster than Imelda Marcos when things are right.*" And, in fact, Berkshire's stock has been hitting all time highs during this market unrest. Buffett has recently made some significant new investments with the \$4.5 billion purchase of Marmon Industries (a privately-held diversified industrial business) and his \$5 billion purchase of Burlington Northern Sante Fe stock -- and we are quite certain that this 77 year-old investor is not thinking or worrying about whether the stock market is going to drop today or tomorrow.

*We expect this increased level of market volatility to continue over the coming months, which, in turn, should provide us with some excellent buying opportunities. **Therefore, if you have excess reserves (whether in cash or securities) available for long-term investments, it is an excellent time to send it in to your Schwab account.***

Closing

As always, we want you to know that we appreciate your business with Aldebaran Capital, and your continued commitment and confidence in our approach. We look forward to continuing to provide you with a sound framework for investing your assets. Please feel free to call us if you ever have any questions, comments, or just want to check-in with us.

Sincerely,

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For those of you in the Indianapolis area, or subscribers to the Indianapolis Business Journal, be sure to look for Ken's articles that appear every other week in the investment section titled "Bulls and Bears."

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