



Value, Performance, & Service

From the desk of:
Kenneth R. Skarbeck, CFA
ken@aldebarancapital.com
(317) 818-7827

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2008 Annual Letter to Clients

Enclosed are reports as of December 31, 2008, which summarize your investment account(s) with Aldebaran Capital, LLC. We would be understating the obvious by describing 2008 as a difficult year. On balance, Aldebaran Capital managed accounts fell *considerably less* than the abysmal 37% decline for the S&P 500 index. That being said, we are well aware of the unsettling feelings that accompany a sizable drop in your portfolio.

There were not many places for investors to hide last year. Only a very few investment choices, such as owning U.S. Treasury bonds, holding a lot of cash, or selling short, would have provided investors shelter from the steep declines. The average U.S. equity mutual fund suffered losses about equal to the 37% loss in the S&P 500 index. To further illustrate how difficult 2008 was for investment managers across the board, consider that CBS MarketWatch's "Mutual Fund of the Year" recorded a loss of 16.9%.

Absolute and Relative Performance

Both the absolute (actual percentage gain/loss) and relative (as compared to market indexes) performance of your portfolio in any given year is one way we keep tabs on how we are doing to achieve attractive long term performance on your portfolio. First, we wish to reiterate to you how we believe our investment strategy and philosophy will prove beneficial to you over the long term. Regarding relative investment results, we would expect that in a declining market, our percentage decline would be less than the overall market...much like what occurred in 2008. In years where the market return is in the middle of the road, say high single-digit type returns, we would expect to outperform. And lastly, in a wildly hyper bull market, we would expect to have trouble keeping pace - that is, in a *speculative* market our performance would likely lag the stock market's return (like our results did during the tech bull market in 1999). Over the long term, we believe this type of mix will continue to provide investment performance superior to the overall stock market...and to date, with over 20 years of documented investment results, that has been the case.

Below is how value investor extraordinaire Warren Buffett described his performance expectations in a letter written to his investment partners, way back in 1962:

"Our job is to pile up yearly advantages over the performance of the Dow without worrying too much about whether the absolute results in a given year are a plus or a minus. I would consider a year in which we were down 15% and the Dow declined 25% to be much superior to a year when both the partnership and the Dow advanced 20%. I have stressed this point in talking with partners and have watched them nod their heads with varying degrees of enthusiasm. It is most important to me that you fully understand my reasoning in this regard and agree with me not only in your cerebral region, but also down in the pit of your stomach."

Therefore, in our case, outperforming the market by about 15 percentage points in 2008 (“*relative*” to the S&P 500) is important in these difficult times, and will pay off even more for us down the road when markets recover.

One additional note... if you had been with advisors who invest using the standard industry approach of fully invested, broadly diversified portfolios, your performance would have been every bit of the market’s decline - *and likely worse* - due to a heavier exposure to foreign markets and the higher investment management fees that many of our peers charge. Losses well in excess of 40% were common in such programs.

We have always shunned the standard (or “conventional”) investment strategies practiced by the majority of our competitors. We believe that blind, over-diversification (which we sometimes refer to as *di-worsification*), is negligent money management. After all, anyone can easily construct low cost diversified portfolios without the need to pay an advisor by simply investing in index funds.

Clients who have been with us for the last ten years have experienced a multitude of market gyrations, and have achieved cumulative results that have outperformed the market averages. Those who have joined us in just the past two years (while our *relative* performance has been good), we appreciate your patience as we work to deliver strong *absolute* returns in the future.

Why We Are In This Mess

By now we are all familiar with the many factors that contributed to the dismal state of our present economy. In recent years, Wall Street firms were busy packaging mortgage loans into securities, in a process called securitization. These securities were sold to banks and other institutions throughout the global financial system earning Wall Street huge ‘fee income.’ Likewise, investment banks and hedge funds were trading these securities with their own capital, using loads of borrowed money and reporting large profits. As the housing bubble inflated, the quality of the mortgage loans deteriorated and huge quantities of poor quality subprime loans were packaged into securitizations. The tipping point happened in July of 2007, when two Bear Stearns hedge funds that had invested in subprime mortgages failed and the unraveling of the financial markets began. Soon, the credit markets ceased to function properly and liquidity dried up as the magnitude of the problem became evident – nearly a trillion dollars of bad loans were held by institutions throughout the global financial system on highly leveraged balance sheets. *The underlying equity of many huge financial institutions was essentially wiped out.*

When the music stopped, our financial system was clogged with massive amounts of borrowed money (leverage). These debts had to be paid back, except that the assets everyone needed to sell were of dubious value. And as everyone tried to sell, prices fell even further, compounding the problem. As these investment assets rapidly lost value, the stocks prices of many financial institutions began to freefall. Eventually, investors deduced that the liabilities of certain businesses exceeded the underlying value of their subprime assets, and the result was the demise of several tenured institutions including Bear Stearns, Lehman, Merrill Lynch, Fannie Mae, Freddie Mac, Wachovia, National City, and AIG. There is ample blame to spread around. Ratings agencies failed in their job amid conflicts of interest and state and federal regulators were asleep at the wheel. Wall Street CEOs ignored the risks they were taking because the paychecks were too good, and in the end, they wrecked the global financial system.

What a sobering exercise it is to peruse the list of wounded and insolvent financial institutions. Pick your adjective, but the devastation that has been inflicted is jaw-dropping.

Outlook

So here we stand today, with markets that remain dysfunctional and no clear solution to get out of this mess. The government is going to take unprecedented measures to bailout the economy, yet there are still more “toxic assets” that need to be recognized as losses and cleared off balance sheets. And housing prices, a key asset in most Americans net worth, must be stabilized for confidence to return to the economy. De-leveraging the global financial system will continue to be a painful process, and more than anything else, it will just take considerable time to cleanse and repair our markets.

So what is an investor to do in the midst of this sea of uncertainty? ***We think you have to be an opportunistic buyer of stocks.*** Throughout history, investors who had the fortitude to step in and buy when the outlook was bleak have been rewarded with attractive long-term investment returns.

In fact, two key investment maxims are at the forefront of our minds these days. Sir John Templeton, the great investor who died last July at the age of 95, was a consummate optimist of mankind and a positive thinker. However, he knew the best time to invest was when people were most depressed about market conditions. His “*Principle of Maximum Pessimism*”, simply states that stock prices reach their lowest levels when the general public is *most pessimistic* about the future.

The other proverb, you have heard from us before. The father of value investing, Benjamin Graham, coined the saying – ***the secret to getting rich on Wall Street, is to “be greedy when others are fearful, and be very fearful when others are greedy.”***

It goes without saying that at present, market participants are very fearful and pessimistic about the future. The stock market is 40% off its all time highs. Consider also, that investors are behaving much like they were in 1999, except the situation is completely *reversed*. Back then, investors were looking in the rear view mirror at the huge returns that tech stocks had achieved and assumed that the market would continue racing higher. And in the early months of 2000, they poured record amounts of money into the market right at the peak (investors were being greedy when they should have been fearful). Today, investors are selling out of stocks, getting out of the market and flocking to the safety of government securities – after stocks have already collapsed in price. Further, they are extrapolating these tough times well into the future; however, history suggests this downturn will end with time (*investors are being fearful, when they should be greedy*). Depressed with the awful performance of the stock market in 2008, investors are looking in the rear view mirror and purchasing treasury bonds, which were one of the best performing assets during the stock market rout. Investors buying government bonds today are locking in meager yields, and worse, although they believe they are being safe with their money, treasury bonds will lose value if interest rates increase at some point down the road.

Now, in managing your account, we aren’t going to behave like the Texas Hold’em poker players and push our chips “all-in” on the next hand. It is entirely possible that economic conditions might even get worse in the near term. ***Therefore, a program of opportunistic buying, in periods where stocks sell down in price, will allow us to capitalize on the pessimistic moods of the market.***

In summary, we believe that the market environment over the next several months is likely to present outstanding buying opportunities to long term investors. Investors who are willing to look beyond the near term, and out 3-5+ years, are going to be well rewarded for buying stocks during this downturn. Therefore, as difficult as it may be to adopt this “contrarian” mindset, it is important that you understand how we are approaching the management of your portfolio during this crisis. **For those eager to take advantage of the market’s pessimism, the present is an excellent time to commit new investment capital to your accounts.**

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,

Kenneth R. Skarbeck, CFA

Edward A. Skarbeck

Richard M. Rockwood

To reach:

Ken – 317.818.7827, option 1
Ken@aldebarancapital.com

Ed – 317.818.7827, option 2
Ed@aldebarancapital.com

Rich – 317.818.7827, option 3
Rich@aldebarancapital.com

For those of you who read Indianapolis Business Journal, be sure to look for Ken's articles that appear every other week in the investment section titled "Stocks / Investing".

Referrals

Over the past several years, the behavior of the "high-browed" Wall Street firms - which enabled such events as the dot-com frauds, Enron/WorldCom, and now the subprime fiasco - has been disgraceful. It is a system rife with conflicts of interest and has demonstrated an alarming lack of integrity.

We believe that strengthens the case for independent investment management firms like Aldebaran Capital. In your conversations, you may find people who are dissatisfied with their brokerage firm or advisor. If so, please have them contact us, or provide us with their name and we will contact them directly. Thank you, in advance, for helping us grow our business!

10293 North Meridian Street • Suite 100 • Indianapolis, Indiana 46290
ph 317-818-7827 • toll free 1-888-742-7827 • fax 317-818-7830
email: info@aldebarancapital.com • www.aldebarancapital.com
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