**LINDMARK CAPITAL FUND, LP**
969 Narrows Point Drive · Birmingham, Alabama 35242 · (205) 991-2935

January 22, 2009

To the Partners of Lindmark Capital Fund, LP:

**Lindmark Capital Fund vs. the S&P 500 Total Return Index**

Annual Percentage Change

| Year | LCF Gross | LCF (1) | S&P 500 TR (2) | Relative Results (1) – (2) |
|---|---|---|---|---|
| 2005[1] | 4.5% | 3.7% | 3.8% | (0.1)% |
| 2006 | 25.9% | 18.6% | 15.8% | 2.8% |
| 2007 | (4.0)% | (6.4)% | 5.5% | (11.9)% |
| 2008 | 64.8% | 47.1% | (37.0)% | 84.1% |
| **Cumulative** | 108.2% | 69.3% | (20.1)% | 49.2% |
| **Annualized** | 26.1% | 18.1% | (6.8)% | 24.9% |

## Our Performance

After a poor performance in 2007, I am delighted to report a very strong performance for 2008. It was a record year for the fund during the worst financial crisis since World War II. The result for the year was a 47.1% net gain to partners, and an 84.1% outperformance of the S&P 500. Anyone expects a year similar to 2008 should reduce their expectations, an outperformance of the S&P 500 of this magnitude is an unrealistically high hurdle. It was a very difficult and stressful year in the money management business and I am especially proud of our results. I greatly appreciate you entrusting your hard earned savings with me.

## Year in Review

As 2008 unfolded, the credit bubble continued to deflate, the equity markets sank with the S&P 500 falling 37% for the year. This was the worst year for the S&P 500 since 1937. Every asset class and market around the world declined significantly leaving investors nowhere to hide. A plethora of various financial institutions either imploded or were quasi-socialized by the U.S. and foreign governments. This process continues in 2009, and unless

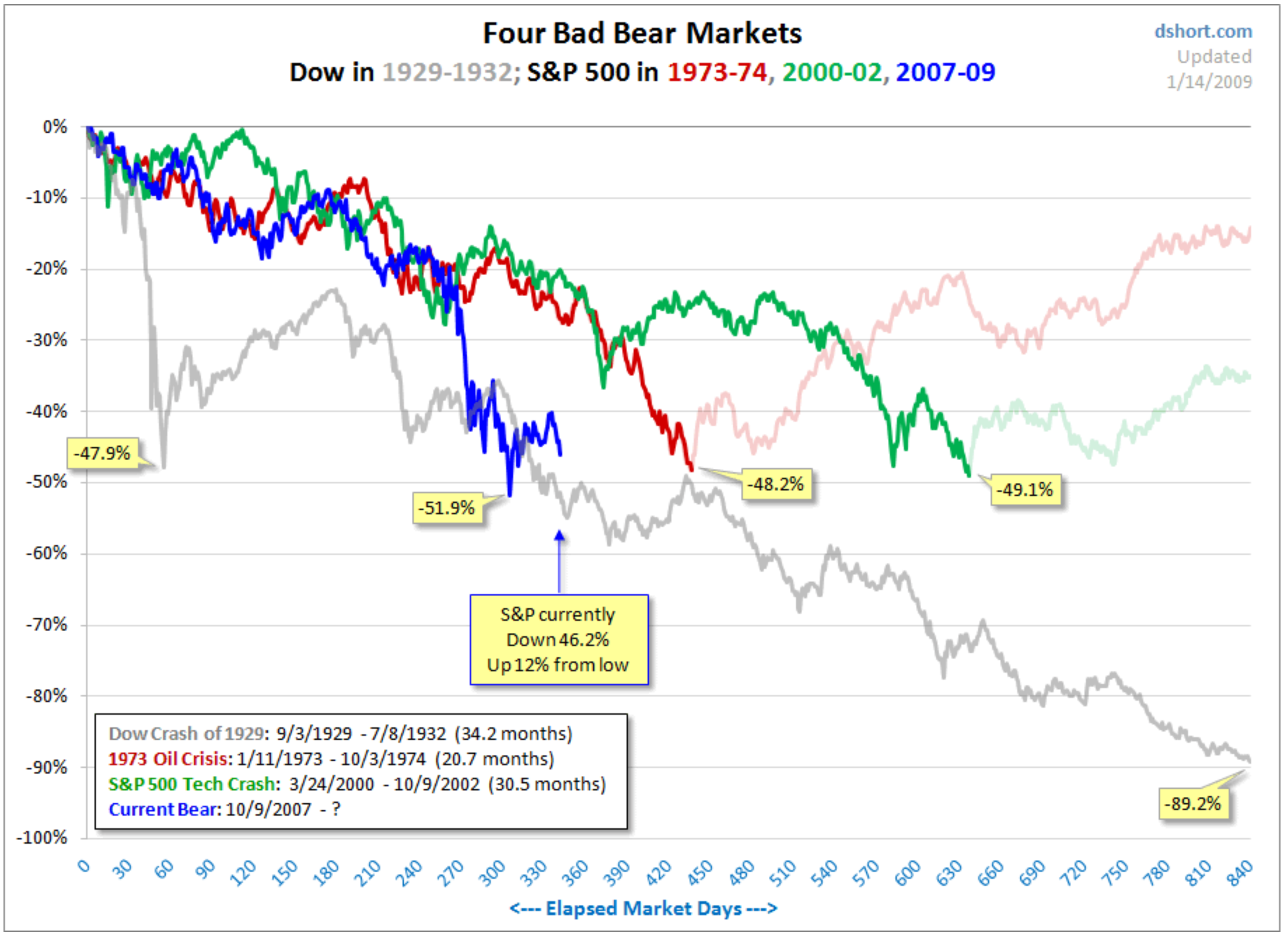
[1] *2005 covers from 11/1/2005(the LP's inception) until year end*

governments completely nationalize their banking systems, capital infusions for financial firms will continue throughout the year. I will not re-hash each individual failure, as I am certain everyone followed the events unfolding in the news.

Housing prices in the U.S. continued their decline. As of the latest data through October, the S&P/Case-Shiller 10-City Composite Index had fallen 25% from its mid-2006 peak, and the 20-City Composite had declined 23.4% from its peak. Throughout the year the Federal Reserve and the United States Treasury created a whole slew of programs, most notable the $700 Billion TARP, or Troubled Asset Relief Program. This program was supposed to buy troubled mortgage backed securities, but the first $350 billion of TARP funds were instead spent on bank recapitalizations. I question whether they had any intent of buying the troubled mortgage backed securities. It seems the new administration is currently trying to set up a 'bad bank' program where they follow through with the Treasury's original intention of buying these troubled assets. The Fed created an official target fed funds rate of 0% - 0.25% on December 15, though unofficially they had been there for nearly a month. The Federal Reserve Chairman, Ben Bernanke essentially went 'all-in' with this final rate cut and through a promise to inject money into the economy through a process which economists refer to as "quantitative easing."

The financial crisis hit a critical point the morning after the Lehman Brothers bankruptcy, when money market funds nearly caused a modern day run on the bank. By 8:30 a.m. on September 15th the $62 billion Reserve Primary Fund, which held Lehman debt, had redemptions for $5.2 billion. The following morning the redemptions had ballooned to $24.6 billion. They only paid out $10.7 billion in redemptions. This created a situation akin to yelling fire in a crowded movie theater, and threatened the financial system. The government was forced to step in and make a partial guarantee of money market assets. Reserve fund investors will not get $1 back for each $1 held in money market assets and this is why in the first quarter letter of 2006 I wrote the following, "The risk of not getting a dollar back for each dollar put into a money market fund is real and a reason we do not participate." We avoided risk here by not using money market funds, except funds which invested solely in United States Treasuries.

Looking back, the year flew by though it contained two to three years worth of events. Investors are currently hoping that the second half of 2009 will be better, using historical figures as my guide I have my doubts. I will close the 2008 summary with the following chart that puts the current bear market into historical context (note that the chart is through 1/14/2009):




**LCF's Activities in 2008**

In the fund's 2005 Annual Letter I wrote:

> *Today risk premiums are at an ultra-low level. The compensation for risk is next to zero  Nearly all asset classes remain fully valued or overvalued by my metrics. Despite being agnostic on the market's directions, I view this pessimistically as I am unable to find many bargain priced investments.*

Finally, in 2008 the risk premium returned to various asset classes.  We were able to take advantage of the return of the risk premium in multiple ways.  First, I implemented short selling in the fund on May 12th, during a rally that followed the failure of Bear Sterns.  Prior to May we were only shorting stocks, sectors, and indices via inverse Exchange Traded Funds, and put options.  The inverse exchange traded funds are inefficient vehicles to short, unless one is betting on very short-term declines.  Puts are efficient but have their various flaws.  The more tools I have to implement our positions the better.

The fund profited from shorting a large number of securities which benefitted from bloated profit margins, the real estate bubble, leverage, excess consumption, overpriced buyouts, and credit bubble in general. The list included: money center banks, regional banks, a private equity firm, broker dealers, hotels, bond insurers, a rating agency, retailers, commercial Real Estate Investment Trusts (REIT's), commercial real estate via the IYR index, a foreign auto maker, a few tech stocks, a solar company, the Euro, a trucking company, retailers, three manufacturers, the Russell 2000 small cap index, and the S&P 500 index. Most of our shorts worked out quite well, but we left a lot on the table by exiting to early, entering before rallies, and most significantly from the short ban on financials in September. I hope to improve significantly in the timing of entering and exiting our short positions and avoid leaving as much of our returns on the table in the future. It was a difficult psychological adaption to go from essentially being long only to a long/short investor.

My wife and I flew to California on September 18th to give a presentation to prospective investors, and to attend another fund managers yearly presentation. Upon landing my good friend Jason Kaspar, who runs his own successful fund, called to inform me that Britain had banned short selling of financials. We deduced that the U.S. would be next to do the same and the logical conclusion not to participate in a game where the government can change the rules at any time. Therefore, I spent the first few hours of this trip with my wife on the side of the road in Beverly Hills covering the fund's short positions. The day was supposed to be a touristy day as we had never visited the area, thankfully I have been blessed with a wonderful and understanding wife.

After determining that the government would most likely not ban short selling altogether the fund entered back into a net short position, mostly by shorting the S&P 500 and the Russell 2000, based on my studies of the markets valuations. This was quite profitable, though it could have been executed better through the use of options in case there was a complete ban of short selling, which may have caused yet another temporary short squeeze. I thought we lived in a capitalistic society but throughout this financial crisis we have grown into part capitalistic and part socialistic society.

When short selling was added to the fund so was the ability to write options as both require the use of a margin account. I was weary of such an account in the past and 2008 helped prove why. Funds who held assets at Lehman Brothers have had a difficult time getting access to these funds, and there is a risk of not getting assets back at all. I closely monitored Citibank's financial situation, ready and willing to switch to a cash account at any time to protect partners capital. Writing options proved to be another profitable area for us, as we wrote out of the money put options on securities. Since volatility had spiked the option premiums skyrocketed, making the endeavor worth our while.

We also made profits on various long positions, and one spread trade. One long investment was Fairfax Financial Holdings which I have followed for a long time. Fairfax is a Canadian insurance company which boasts a successful investing track record. Fairfax's investment team had maintained a bearish outlook on the financial system and the stock markets since 2003. They owned a large book of credit default swaps (CDS) on various financial firms debt. Many of the credit default swaps paid off at multiples of their value as risk was so inappropriately priced in the 2004-2007 period. I attempted to do so in the fund but the fund's asset base was so small we were unable to take advantage of the situation. Through October 24 of this year Fairfax received sale proceeds of $2.1 billion on credit default swaps which they had paid $241.5 million for. On top of that, they still retained CDS valued at $405 million which they had paid only $191.5 million for.

Besides the credit default swaps, Fairfax was also net short the S&P 500, maintained a short position in oil and solar companies, maintained a short position on the Euro, and held most of their portfolio in cash via U.S. Treasury bills or U.S. government bonds. Their government bonds were all long dated so they would participate in the cutting of U.S. interest rates, and the flight to safety that occurs in financial panics. They were set up for what they referenced as a "1 in 50 or 1 in 100 year storm" on the financial markets.

This company was misperceived and had been plagued by an ongoing group of investors who were short the company due to the complexity of its operations. To date the shorts have lost a significant amount of money shorting Fairfax. The market recognized much of the value in this security as it moved up nearly 71% from a 52 week low of $208.15 on September 3rd to a high of $355.62 on October 1st.

Volatility was rampant in the fourth quarter and we took advantage of it in various forms. CDS on Berkshire Hathaway were priced at nearly 5% implying its credit status was junk and that there was 1/20 chance of Berkshire defaulting on its debt. Berkshire is one of only six AAA companies in the world. Although, these days AAA is an oxymoron, I believe Berkshire's credit is one of the better in the world. The CDS widening seems to be the result of broker dealers being forced to buy protection on any credit risk they had, no matter who the creditor was. If our assets would have been larger we would have sold these CDS, and collected the premiums on the contracts. On November 20th, Berkshire's Class A shares hit $77,500, a 50% decline from its high of $149,200 on December 10, 2007. Berkshire subsequently rebounded 42% by December 9th, an unbelievable move for one of the largest companies in the world. It looks as though Berkshire may or may not have further problems with their investment portfolio. If Berkshire were to lose all of its large financial investments such as: Wells Fargo, American Express, Goldman Sachs preferred stock, General Electric's preferred stock, I conservatively estimate it would cost them roughly $16 billion or as much as 15-18% of shareholders equity, depending on where equity is since such as scenario would certainly mark down many of Berkshire's equity investments. This is a very rough approximation as we do not have yearend figures yet for Berkshire, and there are many other undeterminable variables. All in all I believe Berkshire will remain a business able to service its debts and writing credit defaults swaps would have been a tremendous investment for the fund.

The fund made a decent amount of money on hedge funds being forced to liquidate positions due to funds facing large redemptions and forced deleveraging. There was a particular spread trade in which we were able to short Mueller Class A shares and simultaneously go long the Mueller Class B shares.   They both possessed the same economic value, though the class B carried more voting rights, making them intrinsically worth a modest premium.  When we entered the trade the spread was over 20%.  The only downside risks were that the spread could widen, or that it would take a significant amount of time for the gap to close, which would lower our rate of return.  They are currently voting to merge the two classes of shares and the spread will be completely gone, though it is nearly non-existent currently at 1.22%.

Lastly we purchased stock in a consumer brand which was spun-off.  It was to be selling off both due to hedge fund liquidations and due to the technical nature of spin-off securities. Spin-off securities are usually sold-off during the first year of existence as independent companies.  Historically spin-off's have beaten the market handsomely over subsequent years.  We purchased this company because of the valuation, and the degree of safety in their business.  This name rose 28% from its low in December.  All of our investments were in larger securities and we were fortunate for such volatile times to provide us with these opportunities.

Not everything works out as planned, and I will make plenty of errors in my investment career.  In late 2007 and early 2008 the fund lost money on several investments.  When I conducted further analysis I realized that the main variables required for the success of these investments would be impaired as the credit crisis evolved.  I vividly remember telling another hedge fund manager in late 2007 that the flow of credit would most likely come to a crawl.  He responded by stating that as he looked out his window he cannot imagine our society functioning without credit.  Fortunately I try to follow Keynes's famous quote, "when the facts change what do you do sir, me I change my mind."  Had the fund been shorting securities in 2007, we would have shorted two securities which we were briefly long.  I tried to short one in 2008, but the interest rate to the borrow the shares was 50%, ironically even at that rate the short still would have been very profitable.

Other errors in 2008 included initiating short positions too soon, covering shorts too soon, initiating long positions too early, and selling longs to early.  In investing, history proves it is best to lazily enter and exit positions as it is the nature of markets that securities which are falling or rising possess momentum which moves them further down or up longer than one expects.  I have painfully learned lessons in this department and will be entering and exiting positions slower to avoid being too early.  If anyone claims they can buy at the bottom or sell at the top it is best to remember the famous quote from Bernard Baruch "It can't be done except by liars."

We operated with a lower asset base which made it easier to move into and out of our positions.  However, we could have made nearly all of the same investments with a much larger asset base without diminishing returns significantly.  Nearly every investment we made involved larger securities, where liquidity was not an issue. I hope 2009 has as many opportunities as 2008.

**2009 Macro Outlook/Concerns**

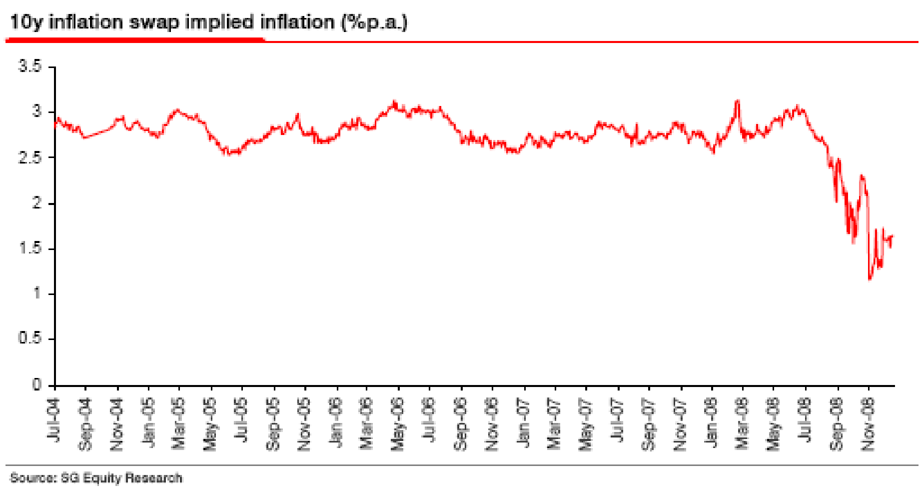
The 2009 macro economic outlook looks quite bleak. My view is that investors and the market will underestimate how badly the economy will be impacted just as many underestimated the severity of the credit crisis. Losses at financial firms worldwide have reached more than $1 trillion since the beginning of the 'crisis' in 2007. The FDIC has now classified 171 banks as "problem" banks in the third quarter, a 46 percent jump from the second quarter. It seems the government agencies have been slow to act throughout the crisis. IndyMac barely made the "problem" banks list shortly before it failed.

Nouriel Roubini, the economist from New York University's Stern School of Business, maintains a very good track record in forecasting the unfolding of the credit crisis. On January 20th he stated, "I've found that credit losses could peak at a level of $3.6 trillion for U.S. institutions, half of them by banks and broker dealers. If that's true, it means the U.S. banking system is effectively insolvent because it starts with a capital base of $1.4 trillion. This is a systemic banking crisis." He may be overestimating the problem, but credible estimates range from $2 trillion to Professor Roubini's $3.6 trillion number, either way it looks to be very ugly. The large money center banks seem to most definitely need more capital, and presently look insolvent. As I am writing this there is speculation of Citibank being nationalized, and others would be sure to follow, not the best way to start the New Year. Bank of America is limping along as well, a report from FBR's Paul Miller on January 20th estimated that they will need $80 billion in newly issued common equity.

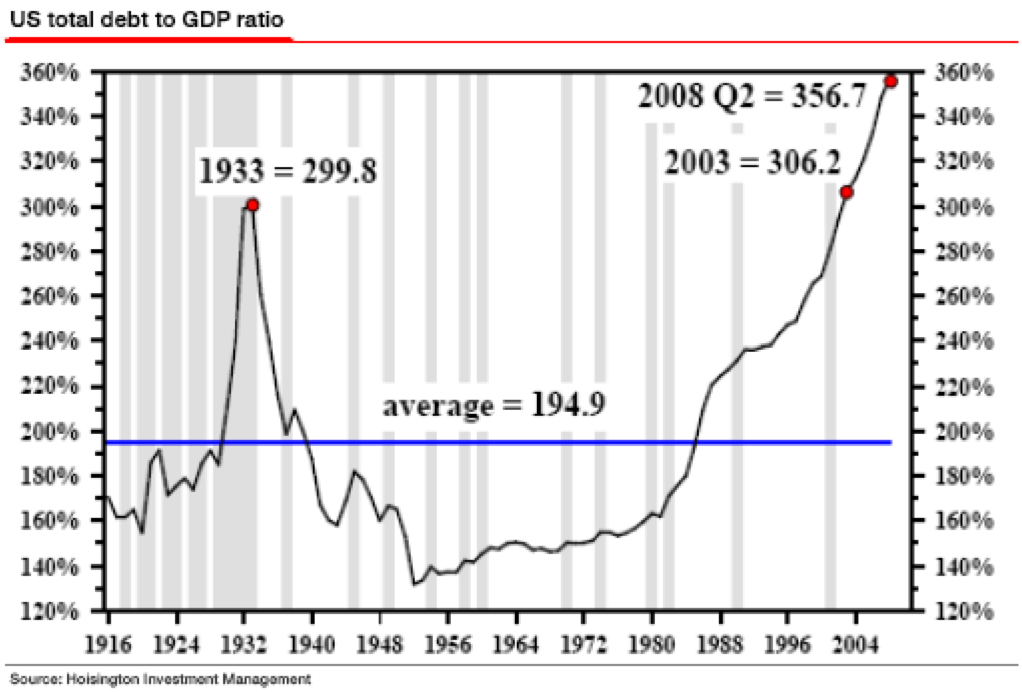
The year will most likely be plagued by more hedge fund failures, the more levered funds should be the first to go. Estimates are for 50% of the $1.2 trillion industry to be out of business before the crisis subsides. In the first nine months of 2008 an estimated 693 funds went out of business, up 69% from the 409 that imploded in the full twelve months of 2007. The most significant market declines did not occur until the fourth quarter, therefore expect that number to rise for 2008, and continue at least through 2009. This will continue to provide us opportunities as trades get unwound and we can take advantage of forced selling. Many funds have locked up their investor's capital, taking away their ability to redeem their investments because the fund managers do not like the market price for the assets which they own. This reminds me of the banks in 2007 and 2008 that needed to raise capital but did not like the prices they were being offered by the market. A notable example is the failed institution of Lehman Brothers who resisted an investment from state-controlled Korean Development Bank, because it was not a high enough price.

The world is currently experiencing a large dose of deleveraging which is creating asset deflation. The government is desperately trying to stop this by reflating assets through the printing of money. The American capitalistic system was built upon a modest amount of inflation and our businesses do not operate very well in reverse. Currently all the money the government has thrown at the problem has only plugged holes. However, if the government can reflate the economy by actually creating an excess supply of money; inflation can become a significant risk, and the economy can return to a level where assets stop rapidly deflating. Time will tell if reflation will happen or not, and it is something I am monitoring closely. To avoid this risk we are looking to invest in equities with brand names and pricing power. Ironically, we are always looking for investments with pricing power because they provide a protection against inflation. Large quality companies currently provide investors with a decent earnings yield which will grow modestly over time and their pricing power provides an inflation protection we desire.

According to the 10 year inflation swaps, implied inflation is running at only 1.6% per annum for the next ten years, as noted in the chart below. If history is any guide we will get inflation again, but the most important question is when. Inflation protection is currently underpriced in TIP's and maybe the market is correct. It would be a very poor idea to buy inflation protection for something that does not occur for three years or more, much of the advantage of it being cheap will be eroded as one's rate of return will be driven down by such a long holding period. The outcomes are too bifurcated and currently deflation is winning by a landslide. It is hard to imagine how we can deleverage for five years, and have inflation at the same time.

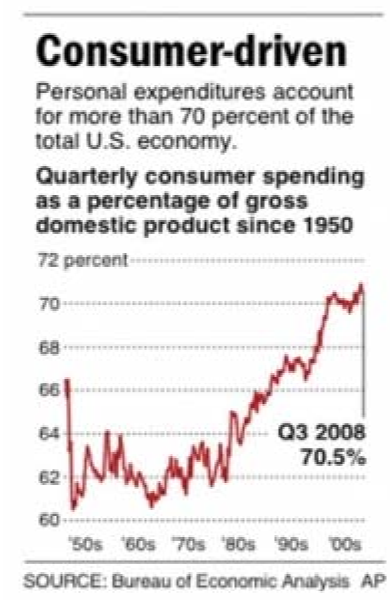



Since the early 1980's the United States citizens and its government have leveraged up year after year. Unfortunately, the government debt is ultimately the responsibility of U.S. citizens through taxes. Legendary bond investor Bill Gross put it excellently in the 2009 *Barron's 2009 Roundtable* "we are all children of the bull market, but the bull market is over." He further expounded "deleveraging will become the context for the next five to 10 years. It will lead to lower profit margins and higher interest rates." I agree with this view though I unsure when we will get higher interest rates, which will be needed to finance our deficits. It is concerning that asset bubbles, fueled by cheap money, helped lead to our current problems and what is the government's solution, to create a new bubble by lending cheap money to everyone rather than cleansing the system of overvalued assets, bad loans, and building up savings. Spending is not always the solution. The terrifying part is we have not even begun deleveraging as one can see from the chart below. We can only hope that the reverse of this process is not as painful I fear it might be!



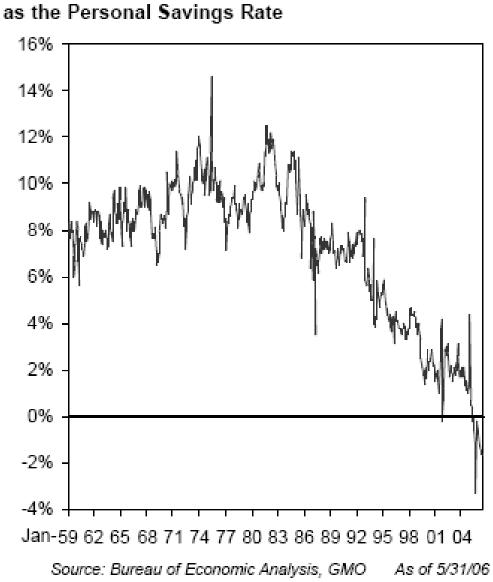

There is also more implicit leverage in the financial system than what is reflected in that chart above. Corporations are levered by having paid such low tax rates for the past twenty years. In the 2005 Annual Letter I wrote, "Corporate tax rates are substantially less than their historical average" and this figure will most likely revert to the mean as the U.S. will have to pay for all of our 'bail outs,' President Obama's stimulus package, the loss of income taxes from the rising unemployment in our country, and the loss of other various taxes including corporations making smaller profits as their margins are compressed. Corporations also have built up a lot of operational leverage. They will have to de-lever their assets to accommodate a lower level of demand which will impact their profit margins.

I've written extensively before on consumer spending reverting to the mean. In other countries personal expenditures account for less than 60% of GDP. The chart below still has us pegged at 70.5%. The United States long-term average is in the low 60% range. If this occurred in one year with no offsets, it would cause a 8-10% decline to GDP.



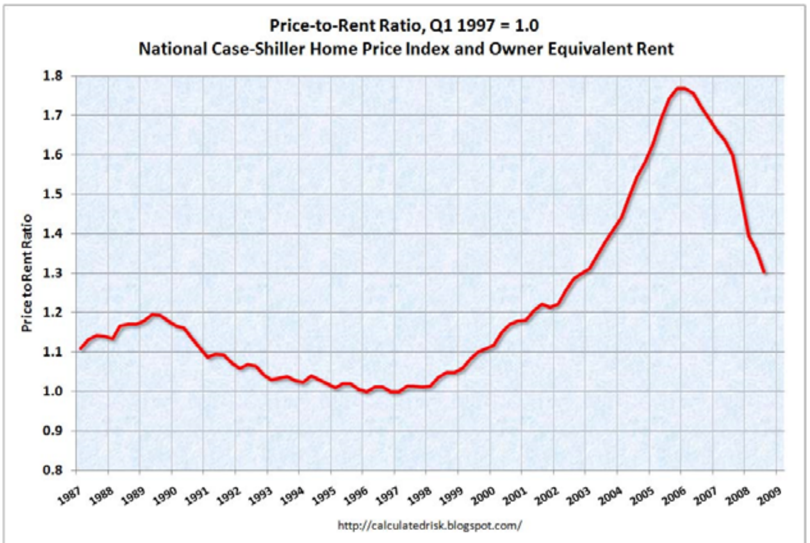

The logical question is where does the decreased spending go? Well some of it is lost as jobs are erased when companies reduce capacity. Unemployment currently stands at 7.2% in the U.S. but U-6, an alternative figure includes employable citizens that have left the work force, or those that have been forced to work part time, climbed to a new high of 13.5%, up from 12.6% in November and 8.7% in December '07. This decreased spending will most likely make up for the dearth of savings as depicted in the following chart.

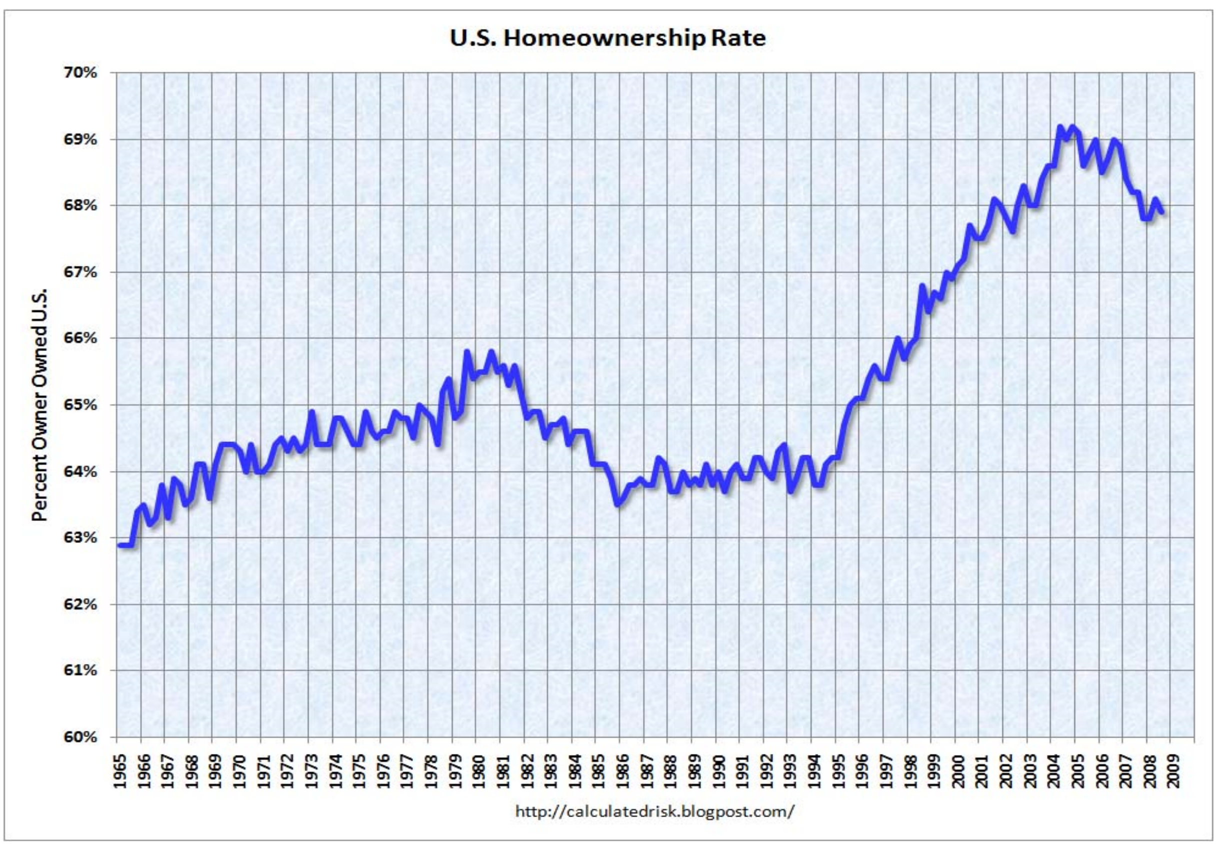
Exhibit 3
The Series Formerly Known as the Personal Savings Rate




Source: Bureau of Economic Analysis, GMO As of 5/31/06

Americans would need to save over 60% of one year's income just to make up for the lack of prior savings. This figure does not include the loss in home values, or the loss in retirement accounts. The savings rate has already moved back up to 2%, but the long-term average is 8% to 10% and we will need to save more than usual for an extended period of time. It will be a good thing long-term for the country. However, it will hurt GDP in the short run and create job losses as our society has been built for excess.



The price to rent chart above shows how much further home prices need to fall. Hopefully, they do not follow the pattern of many bubbles and overshoot. This does not mean that house prices cannot decline gradually, have no appreciation for several years, or that inflation cannot close some of the gap, but until the foreclosures stop and the excess housing supply is diminished the prices will continue to fall. Unfortunately, the foreclosures will most likely continue until the U.S. homeownership reverts to the mean, and we are a long way off from that as you can see in the chart above.

Unfortunately we have a whole new set of mortgages resetting called option ARM's. The problem is larger than the subprime problem and affects prime borrows. The resets begin now and extend for the next three years. This will only exacerbate our current problems. On the bright side the 30 Year mortgage rate hit a new low of 4.96% recently, and the government is doing everything possible to lower it further thus make housing more affordable. This helps stop foreclosures by making it possible for people to stay in their current homes but does not truly change the intrinsic value of a home. I would not be surprised to see the 30 year fixed rate in the mid to high 3% range by year's end. David Crowe of the National Association of Home Builders expects prices to fall another 29 percent this year and new home sales to decline 14 percent. The disturbing scenario is if as many bubbles do, this one overshoots, keep your fingers crossed.

It is not just the U.S. which is experiencing a severe recession, we are in a global slowdown. China's GDP increased at a 6.8% annualized rate in the fourth quarter. This is akin to us having a recession. This rate, which I am very skeptical of given the governments control of their statistics, will most likely decline some more in 2009. 39% of China's GDP is capital spending, 37% is internal consumption, and 37% is exports. Ironically for a country who manipulates their statistics, they do not total 100. China cannot continue to grow by building factories, and selling cheap goods to foreigners. They will somehow have to stimulate their internal demand. This will have affects all over the world. Just today our new Treasury Secretary Timothy Geithner stated he believed that China was "manipulating" its currency. This may stir up more tensions, protectionism is not a good thing in a global economy.

There are major risks exploding in the currency markets. United Kingdom banks have $4.4 trillion of foreign liabilities which are twice the size of their economy. They have only $60.6 billion in foreign reserves to back that up, this is next to nothing. The Swedish system is nearly as bad off. The risk lies in the Pound Sterling which looks to be dead in the future. Currencies do not last forever, and the Pound has made it for quite some time. Other currency dangers lie in the Euro, the logical currency for the UK to join, it has problems of its own. Spain was downgraded on January 20th from AAA and other countries in the European Union, such as Ireland and Greece are suffering through credit problems of their own. In 2009 or further out there could be a dislocation in the currency markets from any of these events as well as the risk that the U.S. dollar could lose its reserve currency status. These are all risks that will hopefully be somewhat minor to investors operating only in U.S.

dollars but things I remain cognizant of for protecting our funds assets.

Lastly, derivatives are still a ticking time bomb. The CDS market needs erase counter party risk, by having an open exchange. Counter party risk wiped out AIG, and that has been a less than pleasant and very expensive experience. According to an article in *The Economist* entitled "The Age of Obligation," the total leverage ratios (on- and off-book assets and exposure divided by tangible equity) for the two biggest U.S. banks were 88:1 for Citibank and 134:1 for Bank of America. These may be overstated ratios, but derivatives still pose a massive danger to the financial system. If the banks had not borrowed huge sum's of money from the Fed they may not have made it this far. In Japan they propped up banks during their crisis and the banks became known as 'zombie banks' because everyone knew they were walking dead institutions. I am hopeful the government has a solution for this sooner than later. I would not be shocked to see some banks nationalized in the process.

The credit losses will continue defaulting prime home loan rates have been skyrocketing and the option ARM problem will only exacerbate this. Credit card losses, home equity lines (HELOC's), and second liens (closed end seconds), commercial real estate, leveraged loans, junk bonds, and bank debt will all be issues throughout the next few years. Municipalities are going to experience default rates that are high from a historical level, especially given the fact that two of the major bond insurers are technically insolvent. California currently faces imminent bankruptcy, though the federal government will most likely bail out the state the U.S. can only do this so many times. State pension funds on average are woefully underfunded. Hopefully, good news will be the subject of future letters but these are the facts mixed with my opinion of how things are unfolding in the macro picture.

**<u>Market Outlook</u>**

Investors have always been an optimistic group and after a historic plunge in all markets in 2008 they remain optimistic. More than three-quarters of money managers expect U.S. stocks to advance this year, while 72 percent say the market is undervalued, according to Russell Investments' quarterly survey of investors whose firms oversee about $10 trillion. Also, here are the current forecasts from the major strategist from a January 5, 2009 Bloomberg article:

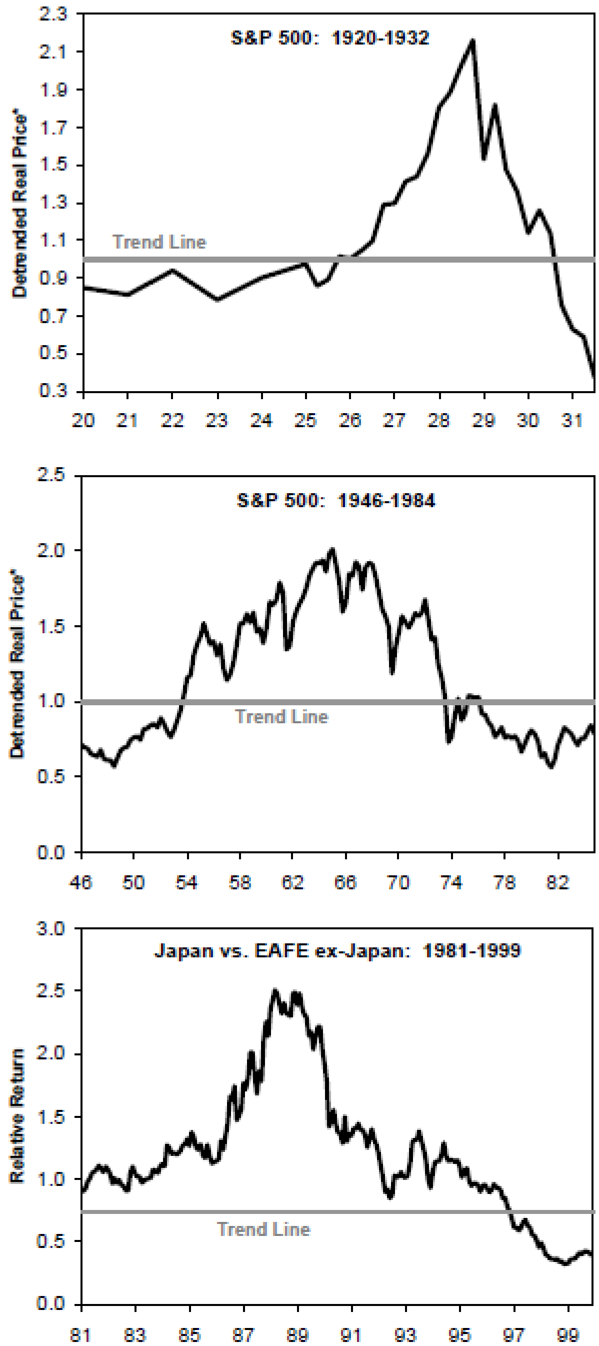
| Firm | Strategist | Target | %Change |
|---|---|---|---|
| Barclays Plc | Barry Knapp | 874 | -3.2% |
| Citigroup Inc. | Tobias Levkovich | 1,000 | 11% |
| Credit Suisse | Andrew Garthwaite | 1,050 | 16% |
| Deutsche Bank | Binky Chadha | 1,140 | 26% |
| Goldman Sachs | David Kostin | 1,100 | 22% |
| HSBC Holdings | Kevin Gardiner | 1,000 | 11% |
| JPMorgan Chase | Thomas Lee | 1,100 | 22% |
| Merrill Lynch | Richard Bernstein | 975 | 7.9% |
| Morgan Stanley | Abhijit Chakrabortti | 975 | 7.9% |
| Strategas Research | Jason Trennert | 1,100 | 22% |
| UBS AG | David Bianco | 1,300 | 44% |

Currently only one of these strategists has a negative prediction for the year 2009! That is a healthy dose of optimism after all the horrible macroeconomic data..

In the 2007 Annual Letter I used optimistic assumptions to arrive at a fair value of 1050 for the S&P 500. I ratcheted down the optimism a little for my September 19th presentation, and arrived at a fair value of 936. These values were intended to be a range with +-10% for errors, as intrinsic value varies and forecasting abilities of individuals are not terribly reliable. From my valuation work stocks are cheap, in fact the cheapest since 1987, but if history is any guide bubbles overshoot to the downside and this one may be no different. Unfortunately we are not to the level where stocks are dirt cheap as they were in 1974, and 1982.

Jeremy Grantham, who runs GMO, a excellent value oriented firm, has studied bubbles extensively. Mr. Grantham recently pointed out in his third quarter letter to clients where the danger lies: "There is also a terrible caveat (isn't there always?), and that is presented in Exhibit 3, which shows the three most important equity bubbles of the 20th Century: 1929, 1965, and Japan in 1989. You will notice that all three overcorrected around their price trends by more than 50%!" Now the danger is these are only three data points, each under different circumstances. Deflation was present in the Great Depression and Japan, while inflation plagued the decline in the late 1970's and early 1980's. It is therefore more difficult to draw a absolute conclusion from the data, but investors should be aware of the potential of a severe overcorrection, though the government is doing everything it can to reflate and stop assets from deflating further.

**Exhibit 3**
**Overrun!**

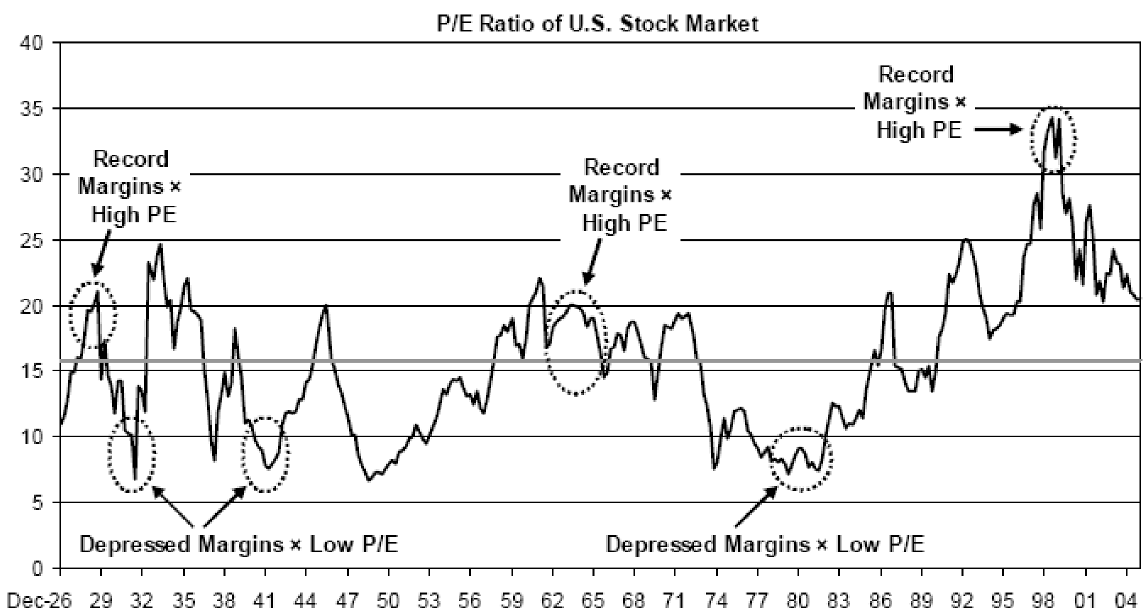



*Note: Trend is 2% real price appreciation per year.*

** Detrended Real Price is the price index divided by CPI+2%, since the long-term trend increase in the price of the S&P 500 has been on the order of 2% real.*

Another way Grantham looked at valuations was to take profit margins multiplied by P/E ratio's in other severe recessions. The argument I have always heard is that when earnings fall off and profit margins are below their mean that the market will assign a higher price to lower profit margins. GMO found this to not be true, and ironically low P/E ratio's and low profit margins actually have a positive correlation of 32% (see exhibit 2 below), unbelievably they still teach that markets are efficient in universities. Using GMO's data profit margins fell 36% to 39% below their mean in the 1982 and 1974 recessions. Using an average of the two multiplied by the normalized margin of 5.4% yields earnings of 37 for the S&P 500. A normal P/E of 15 would yield a value of 555 on the S&P 500, but using a lower P/E of say 12, 20% below its average, would yield a value of 444 on the index. Currently trailing twelve month earnings for the index are 42, meaning the index is still selling at a whopping 19.6 times current earnings. Earnings estimates for 2009 are currently 61 and I believe those are too high. I would not be surprised to see the bottom of this earnings cycle below the 37 I hypothesized above.

**Exhibit 2**
**P/Es and Profit Margins**

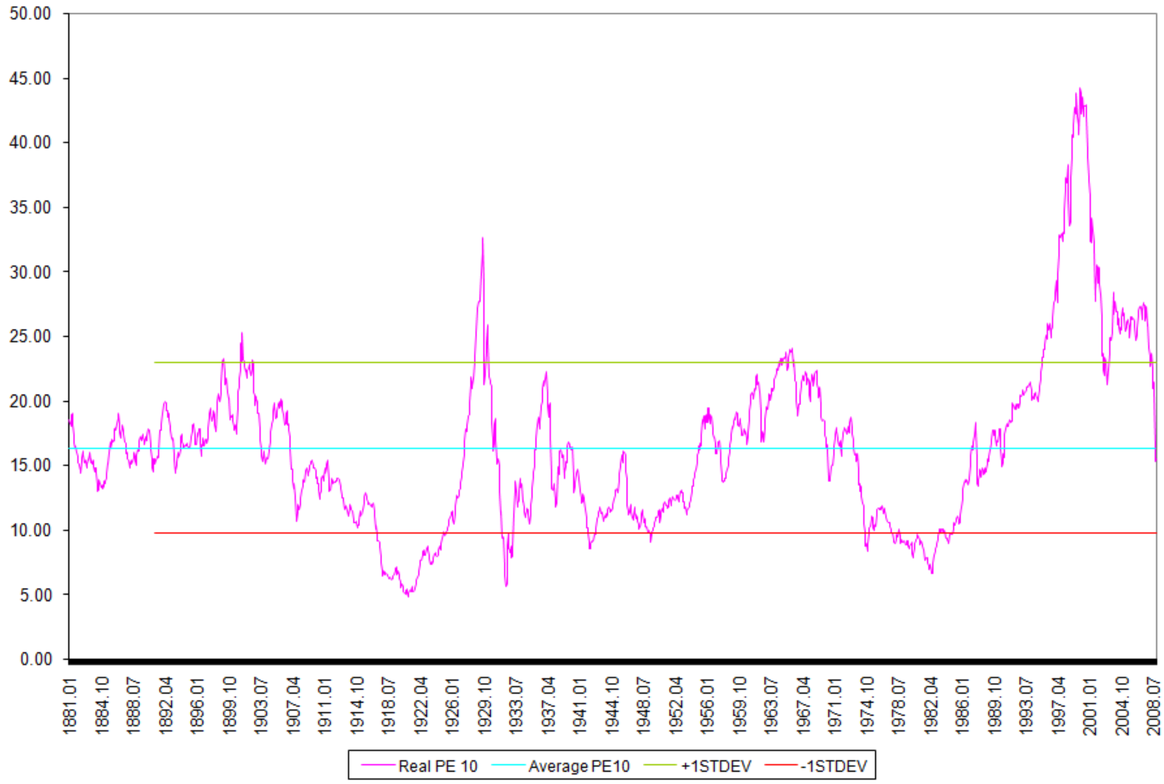



**Actual correlation between profit margins and P/Es is +32%**

*Source: GMO, Standard & Poor's* *As of 12/31/05*

There are multiple ways to value the S&P 500 all of which have historical statistical relevance, and all of which produce similar values. One is Tobin's Q, which estimates the replacement costs of the companies that compose the S&P 500. The ratio has fluctuated between 0.3 and 3 in the past 130 years. Currently it sits at 0.7 down from a peak of 2.9 in 1999. If the ratio were to hit 0.3 it could leave the S&P 500 bottoming out around 400 +-10% for a margin of error. Interestingly enough book value for the S&P 500 was 514 as of the third quarter of 2008, not too far off Tobin's Q's.

The next valuation I believe has historical precedent is the 10 year average real earnings (adjusted for inflation) of the S&P 500 and its price to earnings ratio. The chart below was produced from Robert Shiller's data using real earnings (adjusted for inflation).




The chart shows that late in 2008 the S&P 500 sold at 25 times the ten year average earnings. This was one standard deviation above the mean, or a one in 20 year event by the standard Guassin distribution. Please note in the chart how low the price to ten year average earnings can go. Currently the S&P 500 ten year average real earnings stand at 51.96, in 1934 the market sold at 5.57 times these earnings, and in 1982 it sold at 7.4 times the 10 year average real earnings. Extrapolating that to today's number yields a valuation of 289-384 on the S&P 500. Given the governments quick and massive responses I do not think we will reach such bottoms, but it is my job to not lose partners capital and be cognizant of all risks whether they occur or not.

The last useful valuation to me is to use the normalized earnings and price to earnings ratio of the S&P 500, much like I use when looking at individual companies. Today the S&P 500 has trailing twelve month sales of 1079 through the third quarter. Historically, the S&P 500 has grown sales at 1.8% per annum. If we assume that the sales decline 1% in the fourth quarter of 2008, 5% in 2010 and then resume a lower growth rate for the next four years, say 1.3% per annum, sales would equal 1069 in five years. The normalized operating earnings margin after tax is 5.4%, yielding us $58 in earnings per share for the S&P 500. The historic price to earnings ratio is 14, but let's use 15 to be generous, if all these assumptions are correct, fair value for the S&P 500 will only equally 870 in 2014, making stocks far from cheap. What truly concerns me is how much excess is in the S&P 500's sales figures from overconsumption through the use of leverage.

Felix Zulauf summed up how I have been thinking of the whole situation quite well in the *Barron's 2009 Roundtable*:

> Could it be worse than Japan?
>
> **Zulauf**: It could be worse. Deleveraging usually means return on equity drops below previous cyclical lows. Return on equity for the corporate sector peaked around 15%-16%, and previous cyclical lows were about 8%-9%. ROE probably drops below that in this cycle, which will lead to much lower earnings. That feeds into valuations, which means stocks eventually will go much lower, to single-digit-type P/Es and high dividend yields.

If we do not experience the 1% decline in sales in the fourth quarter, nor the 5% decline in sales in 2010, and sales grow at their historical rate of 1.8% for the next five years the S&P 500 will have earnings of 64 and a fair value of 956. If one purchased the S&P 500 today at 828 they would earn a return of 2.9% per annum plus dividends of 2.5% per annum for a total return of 5.4% per annum.

These various valuations show markets are modestly cheap, and exceptionally cheap relative to treasury yields. The danger is looking back on history is how far markets can overshoot, although it is not a requirement. A quote from Grantham sums up the value investors current dilemma, "After all, if stocks are attractive and you don't buy and they run away, you don't just look like an idiot, you are an idiot." I would expect volatility to remain high, though maybe not as high as October and November. Investors should expect bear market rallies along the way. In 1933 the Dow rallied 66.7% before it completed its 86% peak to trough decline and there is no reason such rallies cannot happen today.

If history is any guide at some point the S&P 500 should bottom in the 400-600 range, plus or minus 10%. However, that does not mean that it has to happen, it just shows that using historical data the S&P 500 *should* bottom out in these ranges. The last thing I want to do is to purchase stocks which are inexpensive to cheap today only to wake up twelve months from now to an equity market which is 50% cheaper. I am sorry but that is not my idea of fun. We will, unless the data and facts dictate otherwise, slowly enter into our long positions the next two years, and also add to current and new shorts through various bear market rallies.

**<u>Our Investments</u>**

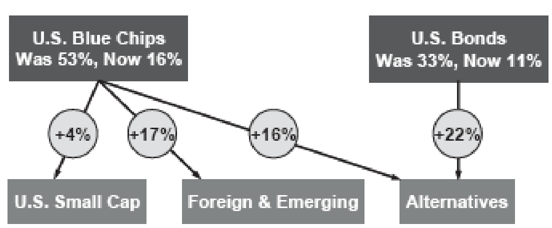
Fortunately, given our small size and large opportunity set we can still find investments to go long in the current environment. As long as investments are cheap on an absolute basis we can compensate for further market declines by buying at very low valuations. Unfortunately, we have found little to do here so far. I hope 2009 is a fertile year for this.

More recently the debt markets have been cheaper than the equity markets. We missed a few opportunities here when various debts were being liquidated by hedge funds such as convertible bonds where hedge funds were long the convertible bond and short the common equity. Given where I expect true default rates to head this may not be our last chance. Good companies with pricing power give us an inflation hedge which is why I prefer equities. We should be able to average down into some wonderful businesses in this cycle.

Currently we have a two spread trades similar to the Mueller trade. As well we are short eleven securities, and long three securities. This can change by the week with the volatility in the worldwide markets. I manage our short and long positions according to the fluctuations in the markets. When a security we are long appreciates 15-20% its risk increases, and the discount to intrinsic value diminishes. In general we would decrease our position to account for the increased risk. The same goes for our short book though this is more difficult as I explained in our second quarter letter to partners.

I expect the fund to end up significantly long higher quality equities by years end. This area of the market along with technology peaked in 2000 and since then most of these high quality names have negative returns from their peak share prices. These names have become more attractive given their stable and dominant business characteristics. Unlike the rest of the market, their profit margins were not inflated. My only concern is how much their sales benefitted from excess consumer leverage. Part of the reason for this existing is depicted in a chart from GMO below. Asset allocation was moved from Blue Chips to U.S. Small Cap's, Foreign and Emerging equities, bond allocations were reduced, and money poured into private equity and hedge funds, which are so eloquently referred to as 'alternative assets.' I believe this chart will revert modestly to the older allocation model, providing fuel for the high quality names to outperform on a relative basis.

Exhibit 1
The Revolution in Asset Allocation and Asset Pricing




Sources: Here & There Data: 1988 to present

Besides high quality, we are always searching for good business which produce high returns on capital that are selling at discounts to their intrinsic value, providing us with a large margin of safety. We will also continue to write options if profitable low risk situations come about. We should find plenty of value in 2009 and I am excited to live through these times where we may be picking among the best bargains since 1982.

**<u>Miscellaneous</u>**

Our expense ratio is still too high given our small asset base. If our asset base had been higher, we would have added 1.5%-2.0% per annum to the fund's returns, with 75% of that predominantly flowing through to partners. I was optimistic in thinking that could be fixed by year's end, fortunately I chose to work on the fund's performance instead of raising assets. I believe our expenses will be down to at worst 1% of our total assets by the end of 2009, and most likely below 0.5%.

Various events happened in the hedge fund industry throughout the year which I need to address. First, many funds have chosen to lock down their funds and bar investors from withdrawing their monies. I will not do such a thing, if an investor calls for a redemption we will be writing a check. There is no reason a fund should hold back investors money because they think securities are underpriced, that is a risk of the business and something that should have been thought of beforehand. Investors are allowed to withdraw money one time a year on December 31st with an advanced sixty day written notice. The only purpose for this is for investors to maintain a long-term outlook on our investments, and to leave me time to prepare for any redemptions.

The second event was the massive fraud, or ponzi scheme, of Bernard Madoff. This seems to be popping up at a few other small funds too. Everyone in the fund currently knows me well and I am easily accessible. All of our assets are at SmithBarney and the fund maintains no bank account. We have a well respected third party administrator in Chicago; Michael J. Liccar & Company. As well we use a smaller but well respected auditing firm in a suburb of Chicago; Jordan, Patke & Associates. Although services provided by Jordan, Patke & Associates has been terrific and they have helped to keep our costs low while we are small, we will chose one of the big auditing firms to keep peace of mind for current and prospective investors when we hit an asset size that makes the cost reasonable. I hope this is enough to provide prospective investors peace of mind, but if there are further safeguards that investors need to sleep well at night, please do not hesitate to call or write.

The audit is in full swing, as well as our tax returns. I hope that our tax returns are on time for the year, but as we experienced in 2007 prepare for the worst as our returns will be more complicated this year. I will keep everyone up to date as soon as I receive any information.

I am still looking to book the Annual Meeting in the Chicago area in the month of April. Current partners, and prospective investors please email or call me to give me an idea how many of you will be attending, therefore I can book it for the appropriate size.

**Closing**

As always, thank you all for your continued support and referrals. I received not one phone call during the year from concerned investors, and only a few emails concerning retirement accounts at other firms. I appreciate the independence you provide me in allowing to me focus on the work at hand. It allows me to focus on finding mispriced opportunities in the market and I am grateful for a wonderful group of partners. I hope everyone is having a wonderful New Year, and please do not hesitate to call or write with any questions or comments in the mean time.

Sincerely,

Peter Lindmark
Managing Partner