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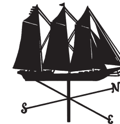

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Third Quarter, 2008

The Importance of Common Sense

> *"Profitable investing is mainly common sense. Don't get carried away by enthusiasm. Don't get carried away by despondency. Don't buy things you don't understand. Always study what you buy in advance. Make long-range plans. Know in advance that you are going to have to live through bear markets. Just use plain common sense and the chances are that you'll have superior long-term investment performance."*
>
> *Sir John Templeton (1912-2008)*
> *Tribute, Outstanding Investor Digest*

The sudden collapse of the financial sector has severely shaken the confidence of investors and non-investors alike. Financial firms have been shattered, Wall Street is demoralized and Main Street is becoming increasingly outraged at the size and scope of both the problem and its resolution. Widespread comparisons with October 1929 make it seem a foregone conclusion that the country, and perhaps the world, is headed for a financial, and perhaps economic, Armageddon.

Obviously, the near-term outlook has been adversely affected. Consumers and businesses are likely to be much more cautious in their spending plans than they were just months ago, and many companies may face liquidity and cash flow problems over the coming year. Some observers believe we may be entering into a prolonged period of economic turmoil and hardship.

But in emotional times such as these, it has always been a sound investment principle not to accept the popular opinion at face value. Whenever things have seemed either the brightest or the darkest, the majority feeling about the immediate future has most often been wide of the mark. True, the waters appear uncharted, and true, the problems seem immense, but this is not the first time we have faced uncertainty, doubt and fear. There have been numerous times in our nation's history when our problems have seemed overwhelming.

For example, during the 45% market plunge of 1973-1974, a nation-wide Gallup poll found that one out of every two adult Americans then believed a 1930s-style depression was in the offing. Instead, shortly afterwards the economy began a strong recovery that endured for nearly five years.

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On October 19, 1987 the stock market fell more than 20%, destroying more wealth in a single day than the world economies generated in the previous two years. However, tax and economic reforms enacted before the crash kicked in shortly afterwards, laying the foundation for economic recovery and an extended period of strong growth.

Ten years ago, the hedge fund Long Term Capital Management imploded and sent the swap and credit markets, then the backbone of the global financial system, reeling. Some of the world's largest financial institutions were decimated in the aftermath. But the financial system did not collapse and economies around the world continued to expand.

Whatever happens, it is clear that this crisis will not be forgotten quickly. We thought this an excellent time to review the factors underlying the credit crisis and the investment outlook over the near term.

The Underlying Factors

A year ago, we looked at some of the issues then unfolding in our newsletter "*Behind The Credit Crunch.*" Basically, the development of securitized financial instruments on Wall Street drastically altered the relationship between lenders and borrowers. Because lenders no longer kept loans on their balance sheets, they had little incentive to ensure the capacity or willingness of borrowers to repay. And as the financial instruments grew in complexity, it became increasingly difficult to predict what might happen under different "what if" scenarios.

The vast amount of liquidity pumped into the financial system in the wake of September 11, 2001 and the extended period of low interest rates that followed did not help matters much either. Wall Street responded to these conditions with further innovations, many of which were designed to generate high rates of return at a time when prevailing interest rates were historically low.

Financial institutions around the world participated in many of these innovations, and also benefitted from the ample global liquidity. When the housing market bubble burst, both here and abroad, conditions tightened and financial firms around the world were affected. Now the piper has to be paid and many are wondering what's next in store.

Repairing The Damage

While the effects continue to ripple outward, it is still too early to know the full extent of the damage. Without a doubt, the landscape on Wall Street has been changed and the global financial industry transformed. With any luck, confidence and order in the financial system will soon be restored. A look back at a truly devastating crisis and how it was dealt with may be instructive.

The stock market crash of 1929 and the Great Depression that followed were transformative events, affecting everyone then alive. Upon accepting the Democratic nomination for president in 1932, Franklin Roosevelt promised a "new deal for the American people."

As President, Roosevelt sought an unprecedented number of reforms in the wake of the devastation wrought by the crash and the failed government policies that followed. Congress was so desperate it gave him carte blanche and essentially rubber-stamped his proposals in order to expedite the reforms. There was no blueprint, road map or strategic plan for anyone to follow -- some of the reforms worked while others did not. In many ways, the New Deal was formulated on the fly over time.

More than seventy-five years later, our society has the benefit of having gone through that, and other events. We have the benefit of three quarters of a century of experience in dealing with crises of varying magnitudes -- most, by the way, caused by Wall Street.

It is comforting to note that the heads of the Treasury Department and the Federal Reserve seem well qualified to deal with the current situation. Henry Paulson, the Secretary of the Treasury, was head of the Wall Street firm Goldman Sachs, which has been front and center in recent weeks, while Benjamin Bernanke, the Chairman of the Federal Reserve, studied both the Great Depression and the New Deal in great depth during his academic pursuits.

"It's An Ill Wind That Blows No Good!"

Though it's a high price to pay, the current crisis is spurring some favorable long-range developments. First, it is forcing the Administration, Congress and Wall Street to deal with a problem that has been festering for more than a year and which has not gotten better on its own.

It is important to note that while the sum being proposed as part of the government bailout seems huge, no one really knows what the final cost will be. Fixing the problem could end up costing a fraction of the total amount requested or it could cost significantly more. Having a bailout plan will provide some structure to the process; otherwise the crisis will continue to be dealt with on a case-by-case, firefighting basis.

Second, the crisis is stimulating greater coordination of effort among the world's central banks. Because of the global nature of the crisis, central banks around the world have been working in close concert. The U.S. recently offered financial support to several countries in an effort to keep the crisis from accelerating.

Third, at the end of the day the crisis will likely have forced some lightly-regulated entities and activities out into the daylight. For the past several years, there have been accusations of market manipulation, in the commodity markets as well as others, and the end result will essentially be a purging of both bad financial instruments and practices. While there is always the danger of too much new regulation, overall the global financial system should end up in much better shape than it has been for years.

Getting Back To Basics

On the investment side, the credit crisis and its aftermath will alter, and perhaps exterminate, some of the financial games that were being played on Wall Street under the guise of investing. For example, many investors in recent years were encouraged to venture into areas where potential rewards were highlighted, risks downplayed and little attention was paid to fundamental characteristics. Now some investors are discovering, the hard way, the real difference between investing and speculating.

It is likely that the economy will soon be in recession. But long-term investors should keep in mind that since World War II, stock prices have gone up, on average, during periods when business activity went down.

Now more than ever, long-term investors should focus on high-grade growth companies with consistent, long-term growth in their earnings. Amid the present uncertainties, it is far better to be invested in these companies than in run-of-the-mill firms with less dependable earnings growth and less ability to weather economic adversity.

We expect the majority of these high-quality companies, such as those we have recommended over the years, to come through this period relatively well. Typically, their managements are experienced in operating under a variety of business and economic conditions. These superior companies tend to have less debt than the average company as well as high levels of cash in the "corporate kitty." Their revenue and earnings growth are strong as they continue to introduce new products and services and expand into new areas.

Many of these superior companies are now being appraised at 17-19 times 2008 estimated earnings and at 16-18 times projected 2009 results -- appraisals which are historically attractive. Obviously, seeing one's stocks decline in price is an unpleasant experience, especially when fear is on the rampage. But the current crisis will get resolved and the stock markets will improve. We suspect that at some point soon, the fact that many superior companies are selling at near-bargain levels will attract the attention it deserves on Wall Street.

Conclusion

During economic turmoil and major declines in the stock markets, many investors assume the damage is permanent. But the intrinsic worth of a portfolio does not change unless the fundamental characteristics of the investments have changed. As long as the companies owned continue their trend of growth in earnings and dividends, their publicly traded common shares will eventually reflect this progress.

The credit crisis is likely to be long remembered. Recent events will serve as a reminder -- especially to today's host of newly seasoned, crisis veterans -- that there is no free lunch and, more importantly, that investment quality is ignored at great peril.

Keeping an optimistic outlook can be difficult, especially when everyone "knows" the outlook is dire. But experienced investors know that a level-headed approach is the best way to attain investment success over the long-term. After all, it's just common sense.