

# CHESWOLD LANE ASSET MANAGEMENT, LLC

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## INTERNATIONAL HIGH DIVIDEND STRATEGY

### 3RD QUARTER 2008 INVESTMENT LETTER

Thank you for your continued interest in Cheswold Lane's international value equity strategy. During the 3rd quarter 2008, our investment strategy composite returned -22.4% on a gross basis compared with a decline of 20.6% in the MSCI EAFE (Morgan Stanley Capital International Europe, Australasia and Far East Index) including income, net of withholding taxes and expressed in US dollars. Year to date, our investment strategy composite has returned -33.4% on a gross basis compared with a return of -29.3% for the MSCI EAFE Index.

#### ***Market Review & Outlook – 3Q 2008***

The third quarter 2008 marked the end of the commodity boom and coincided with one of the worst quarters in decades for the global equity markets. Economically sensitive sectors especially energy and basic materials led the markets lower. Commodity prices peaked during the summer as demand from developed economies noticeably declined. Consumers in the US and Europe continued to reign in spending in order to de-lever. Consumer and corporate confidence surveys reached recessionary levels. Somewhat unexpectedly, Chinese demand for commodities has been extremely subdued post the Summer Olympics. For many commodities, especially metals such as copper, iron ore, and aluminum, China represents 25-30% of world demand and has been growing 20-25% per year. Thus, a deceleration in Chinese demand is having a significant effect on global commodity prices. However, the largest negative event for the global economy occurred in September when the markets were shaken by a series of financial institution failures and government rescues including: Lehman Brothers, AIG, Washington Mutual, Freddie Mac, Fannie Mae, Bradford & Bingley, Dexia, Hypo Real Estate, HBOS, and Fortis. The bankruptcy of Lehman Brothers crippled the debt markets and accelerated the global economic downturn. With the major credit markets frozen, the economic outlook has turned very negative as we await the effects on the "real" economy. It's critical for the major governments to restore confidence in the credit markets in order to get the global economy moving forward again. Until this occurs, equity markets will continue to remain extremely volatile with a downward bias.

Market valuations are very attractive but are dependent on the level of retrenchment in the global economy. For example, many cyclical industries are trading at mid single digit P/Es – steel, oil, capital goods, autos, etc... However, if the credit markets don't re-open soon then the 2009 and

2010 earnings revisions will be quite severe. This is one of the reasons why the markets are so volatile – the range of economic outcomes has expanded, with a clear negative bias, but more importantly, market participants’ confidence has diminished significantly.

### *Portfolio Review – 3<sup>rd</sup> Quarter*

Cheswold Lane’s performance was impacted by the volatility in the markets. Relative strength in the portfolio’s telecom, consumer staples and utilities holdings were more than offset by the sharp decline in our materials, financial and energy positions. Our fundamental research of the supply/demand balance of the oil and steel industries leads us to continue holding stocks in these economically sensitive sectors, but we remain very cautious on most other cyclicals including: industrials, real estate, metals/mining and consumer discretionary. Overall, the portfolio remains skewed towards the historically defensive sectors of the market. Unfortunately during this unprecedented market turbulence, all sectors are suffering significant losses. The two relative outperforming areas of the market were Japan and healthcare.

We have started to make significant changes to our financials portfolio as the “winners” in a post financial crisis world are becoming clearer. They include: BNP Paribas, AXA, Credit Suisse, and Nomura. European banks with credit concerns and a dependence on wholesale funding markets have suffered disproportionately during the financial crisis. Laggards in this group included: Allied Irish, Barclays, Unicredito, Bank of Ireland and Irish Life. The European Central Bank and Bank of England have introduced a number of initiatives to help these banks, but they continue to suffer under credit, liquidity, and capital fears. During the quarter, we added one new financial stock, Daiwa Securities, and sold our holdings in Old Mutual and Commerzbank. Other significant changes in the portfolio include the addition of the multi-national food company, Nestle, and the Japanese pharmaceutical company, Takeda. We continued to reduce the portfolio’s exposure to the consumer segment of the economy by selling Honda Motors and Richemont, the holding company for the high end jeweler – Cartier. Going forward, we expect the near term quarterly earnings reports of many of our holdings to show more resilience than the market currently believes. We maintain our view that the financials are the critical sector to watch for a “bottoming-out” signal in the equity markets. Admittedly, many major banks need to increase their equity capital in order to restart the flow of money into the real economy. However, valuations remain extremely depressed in this sector on very low forward expectations.

Best regards,

Colleen Quinn Scharpf  
Eric Scharpf  
Matt Taylor

## THE VIEW FROM CHESWOLD LANE...

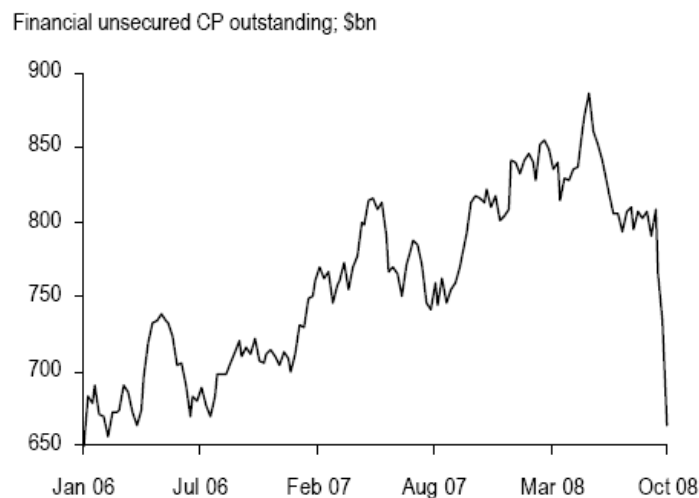
### *Panic and Perspective*

The global markets took a significant downward step during September and sheer panic set in during the first few weeks of October. The primary driver is the seizing up of the global credit markets. From a big picture perspective the causes of the crisis are well known – excessive leverage in the global financial system, the bursting of the US housing bubble, massive US Sub Prime/Alt A mortgage defaults, severe US and European commercial and investment banking write-downs, and the bail out of Bear Stearns.

What changed during September was the fall of Lehman Brothers. The US Treasury department allowed a major US financial institution to file for bankruptcy, meaning bondholders and other creditors were going to lose significant amounts of capital. How did this happen? Besides the gross mismanagement of the firm by its former CEO and Board, the ultimate decision made by the US government was driven by politics. Having bailed out Bear Stearns and with the demise of the GSE's looming, the political powers of Washington, on both sides of Pennsylvania Avenue, needed to show their constituents discipline and fairness. The White House wanted to demonstrate that they still had “*free market*” credentials, while Congress refused to “*bail out Wall Street before helping Main Street.*” – Especially in an election year.

Global credit markets quickly reacted to the negative outcome and rapidly began to reallocate their capital away from the global financial sector. Commercial paper and interbank lending, two critical wholesale funding vehicles for banks around the world, began to seize up. Institutional fixed income investors such as money market funds refused to buy the commercial paper of many US and European financial institutions after suffering significant losses due to Lehman Brothers' failure. The graph below shows the rapid decline in outstanding issuance of US commercial paper by the major financial firms – of which more than 40% of this issuance is from European banks raising wholesale funds in the US.

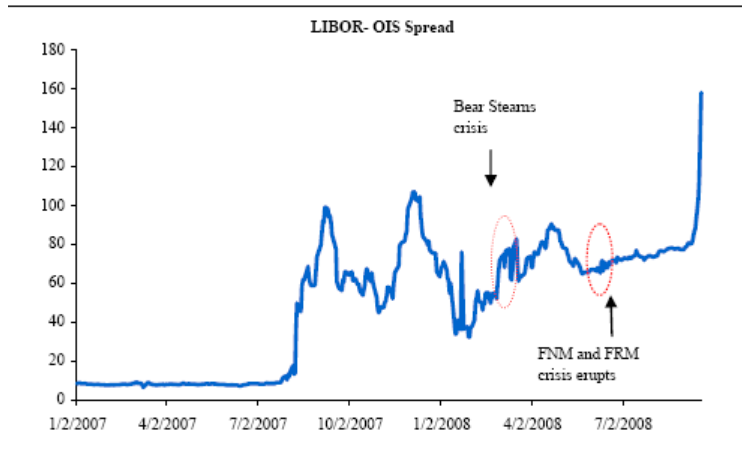
### **US Commercial Paper Outstanding (in Billions)**



Source: Federal Reserve

Additionally, interbank liquidity quickly dried up and any funding that was available to banks and investment banks was at very expensive rates and short maturities – like overnight! The trust between financial institutions around the world was broken. There are many fixed income metrics used to demonstrate the lack of liquidity or stress in the wholesale funding market. One common measure is the LIBOR /OIS spread which is the cost of overnight funding for banks versus US Fed Funds. As you can see the spread has been very wide since August of 2007 with several severe spikes – the most recent one being the bankruptcy of Lehman Brothers.

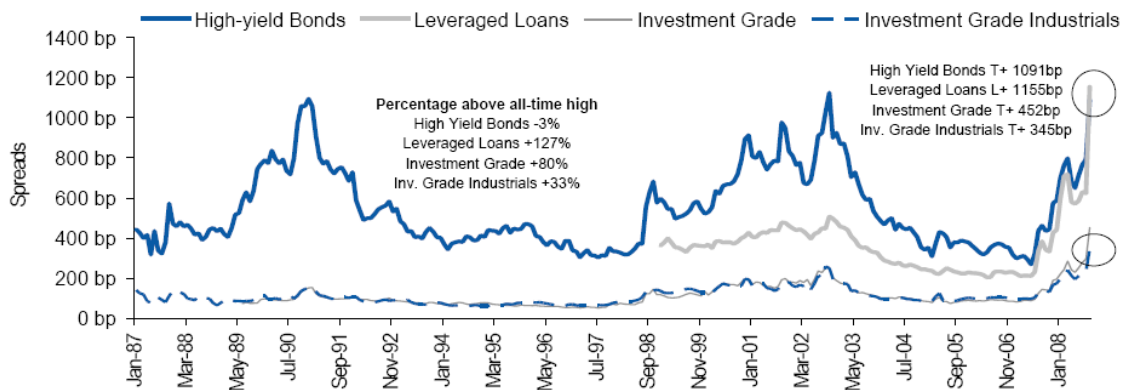
### Bank Funding Versus Fed Funds



Source: Morgan Stanley Research

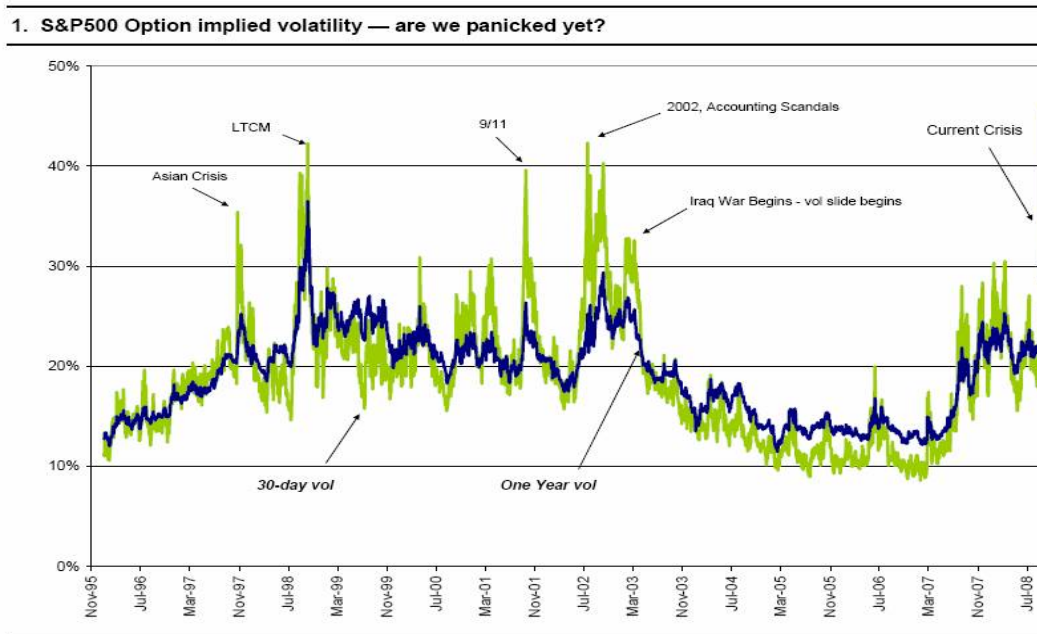
Liquidity throughout the debt markets has been severely reduced as financial institutions are being forced to de-lever rapidly. Debt spreads have blown out to previous recession highs across all grades of corporate bonds. High yield debt investors endured significant losses as credit risk adjusted to the potential for a deep global market recession. The debt markets in Europe experienced this extreme move as well. In late September, emerging market fears caused developing world debt spreads and foreign currency values to decline significantly.

### US Debt Spreads to Treasuries



The reaction in the global equity markets were the most acute. First, the economically sensitive stocks and financials were beaten down, but by the second week of October, when pure panic set in, even defensive stocks like pharmaceuticals, consumer staples, telecoms and utilities were being sold off severely. Retail equity mutual fund redemptions spiked forcing portfolio managers to liquidate positions across all equity asset classes – US, International and Emerging Markets. The “VIX”, a measure of monthly equity market volatility, and often referred to as the “Fear Index”, rose to 15 year highs, surpassing levels seen in other market crises including the Asian Debt Crisis, LTCM, Enron/Worldcom and 9/11.

### The VIX – Often Referred to as the Market’s Fear Index



Note: One-year and one-month option implied volatility for S&P500. Last data as of 10/2/08.  
Source: Nomura Securities International Inc. and Optionmetric.

VIX is the ticker symbol for the Chicago Board Options Exchange Volatility Index, a popular measure of the implied volatility of S&P 500 index options.

#### Is there a solution to the market crisis?

Yes. After last week’s global stock market panic, the G-7 recognized that they risked a deep recession and possibly depression if they didn’t act quickly and decisively. In truth, it often takes a crisis for politicians to put aside their ideology and partisanship, and in the case of Europe, nationalism, in order to resolve major problems. The real economy and real people – i.e. voters, are scared about their jobs, retirement accounts and small businesses and they want significant action now. To use a medical analogy, the US and major European governments had only been treating the symptoms of the financial crisis and not the root cause. Central banks added liquidity, lent short term money to banks on easy terms and lowered interest rates while Treasury departments guaranteed deposits, relaxed regulatory standards and accelerated mergers & acquisitions among financial institutions. But these are just the symptoms of the real problem – which is the broken trust between the global credit markets and the major financial institutions around the globe. Creditors believe the major banks in the US and Europe are undercapitalized and they will not lend

to them until they remedy this. At this stage, the only way to regain this trust in the global financial markets is for governments to inject equity capital into the banking systems around the world. And that is what the major US and European governments have finally done. Private equity capital attempted to do this at various times during the financial crisis but at this point only governments can put the financial system back together. It's pretty clear from the economic data seen in the last few weeks that the global economy has slowed dramatically due to the credit crisis. Many developed countries will experience economic contraction in the 4<sup>th</sup> quarter of 2008 and most likely the 1<sup>st</sup> quarter of 2009. But the stock market is a forward discounting mechanism and valuations are very attractive on a historical basis. The key for the markets is to get credit flowing again and to bring stability and confidence back to consumers and corporations. Government and corporate investment spending must continue as consumers de-lever their balance sheets.

*What is Cheswold Lane doing to manage through this difficult environment?*

There are several portfolio management strategies that we are employing to improve our performance during these challenging economic times. First, we are reviewing each of our holdings and eliminating the least attractive positions in light of the most likely economic outcome for 2009 – Recession. Second, we are using market volatility to upgrade the quality of our portfolio. Third, with respect to sector weights, we are reducing our exposure to deep cyclicals and consumer segments of the market - primarily industrials, materials and consumer discretionary stocks. Financials continue to be a significant weight in the portfolio but the quality of the holdings is improving as the “winners” are becoming more evident. Fourth, we are being patient – buying stocks on days when the market seizes up. Fifth, we are watching the debt markets, because the equity markets can't start working again until the credit markets recover.

I know this has been a challenging couple of quarters in the international equity markets and I thank you for your continued support.

Eric Scharpf  
Portfolio Manager  
Cheswold Lane Asset Management, LLC