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INTERNATIONAL HIGH DIVIDEND STRATEGY

2008 ANNUAL INVESTMENT LETTER

Thank you for your continued interest in Cheswold Lane's international value equity strategy. In 2008, our investment strategy composite returned -48.24% on a gross basis compared with a return of -43.38% 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. In the 4th quarter of 2008, the portfolio returned -22.34% on a gross basis compared with a return of -19.95% for the MSCI EAFE index.

Market Review – 2008

2008 marked the end of the era of “financial engineering”. The bubble associated with third party entities originating consumer loans *with no recourse* that the financial wizards of Wall Street and Canary Wharf packaged, sliced and distributed around the world has burst. The conservatively estimated \$1.5 trillion in losses is simply staggering. In its wake, the era of financial engineering took down such venerable US firms as Bear Stearns, Lehman Brothers and Washington Mutual, while in Europe the fatalities include Fortis, Dexia, Northern Rock, Anglo Irish and Hypo Bank. This is not to mention the near death and partial nationalizations of UBS, Citigroup, Royal Bank of Scotland, Merrill Lynch, Lloyds, Commerzbank, ING and HBOS. Fortunately, this sad chapter in financial market history is close to an end. Our impression is that central bankers, government policy makers and regulators in the US and Europe have generally agreed that its time to act decisively and with finality to put the global credit markets back together; that the free flow of credit must be available to worthy businesses and consumers if we expect to start growing the global economy by the end of 2009. Trust within the financial markets must be restored. If that requires government loan guarantees, good bank / bad bank schemes or more direct equity injections – then it must be done.

The lead story in the first half of 2008 was China and its insatiable appetite for raw materials – iron ore, coal, steel, copper, and of course, oil. Commodity prices soared as demand continued to grow for most major commodities, driven by China's massive infrastructure build-out. With sustained higher commodity prices inflation started to creep into the major developed economies. However, with the sub prime housing crisis only in its 3rd or 4th inning, the Federal Reserve was forced to cut interest rates to protect consumers from adjustable and teaser rate mortgages that were going to reset at substantially higher rates in 2008. Market participants, fearing inflation

poured into commodity investments – buying financial, corporate, physical assets. Declining US interest rates drove the dollar lower and global inflation fears higher. Like most bubbles, the commodity bubble had some basis in truth and, of course, it had an *alluring premise* – a billion Chinese and seven hundred million Indians about to march through their economic development “S curve” *requiring more and more natural resources each year!* Our belief is that most commodity markets became financially driven and prone to market manipulation. But like all manias, the commodity boom ended as well.

The second half of 2008 was about the deepening financial crisis driven first by the recognition of the subprime crisis and second by the realization that the financial system was grossly over leveraged. The global financial system crashed when the US government allowed Lehman Brothers to file for bankruptcy. During the panic that ensued, the markets experienced multiple six-sigma events. For example overnight interbank lending spreads rose ten-fold in several days, commodity prices were cut in half in a matter of weeks, equity market volatility, as measured by the VIX, tripled, investment and speculative grade spreads to treasuries escalated to levels not seen in the last 30 years. By the end of November, there was not a market, other than government bonds, that had not sustained a catastrophic decline in value. Commodities, bonds, stocks, property, private equity, hedge funds – it didn’t matter, asset values around the globe had declined in a highly correlated and unprecedented manner. After a modest rally in December, most equity markets registered declines of 40-50% for 2008. In the equity markets, there was no place to hide; only relatively better places.

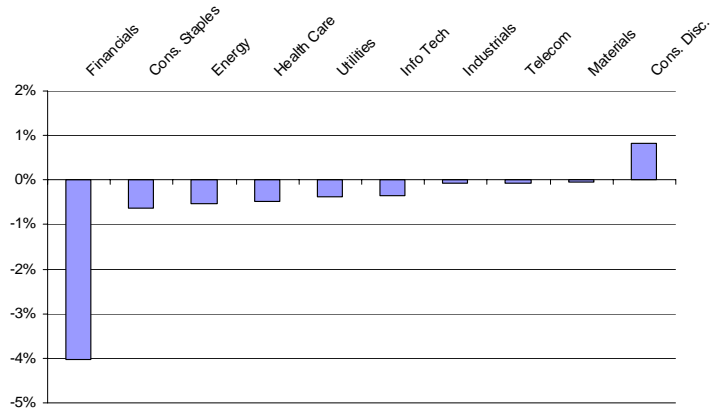
INTERNATIONAL STOCK MARKET RETURNS %

	<u>Local</u>	<u>USD</u>
Nikkei 225	-41.14%	-26.51%
S&P 500	-37.00%	-37.00%
FTSE 100	-27.99%	-47.06%
EURO STOXX 50	-41.83%	-44.34%
Hong Kong (Hang Seng)	-46.39%	-46.05%
Australia (ASX 200)	-37.43%	-49.71%
Brazil (Bovespa)	-41.22%	-55.03%
Russia (MICEX)	-67.20%	-72.72%
India (Bombay 500)	-57.57%	-65.65%
China (CSI 300)	-65.52%	-63.11%

Portfolio Review – 4th Quarter & 2008

When reviewing our portfolio’s disappointing 2008 results, it doesn’t take very long to understand why we had so much trouble during the year. The chart on the next page tells the story – extremely negative attribution in the financials sector.

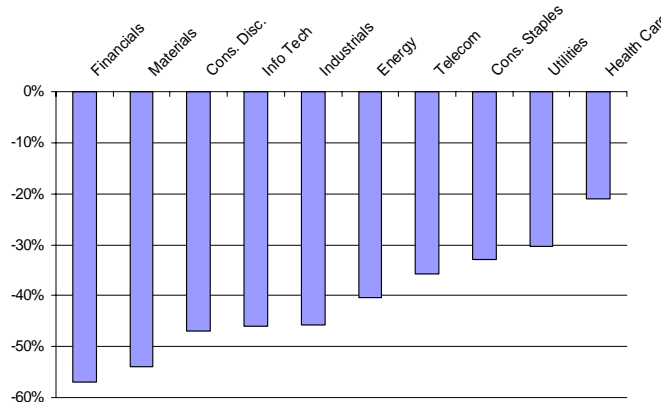
CHESWOLD LANE 2008 SECTOR ATTRIBUTION



Source: Cheswold Lane

This was driven by poor stock selection primarily in the European bank and insurance sector. Financials have now been the worst performing sector in the international markets over the last 2 years. In 2008, the sector was down almost 60% in absolute terms which was approximately 20% worse than the international index (see chart below).

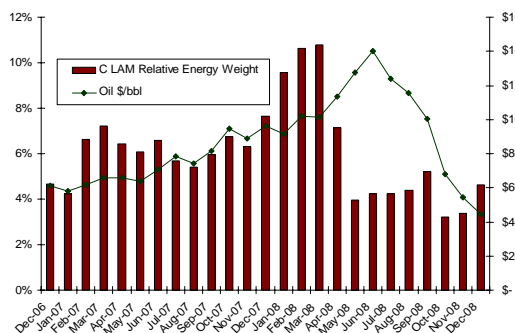
2008 MSCI EAFE SECTOR RETURNS % (USD)



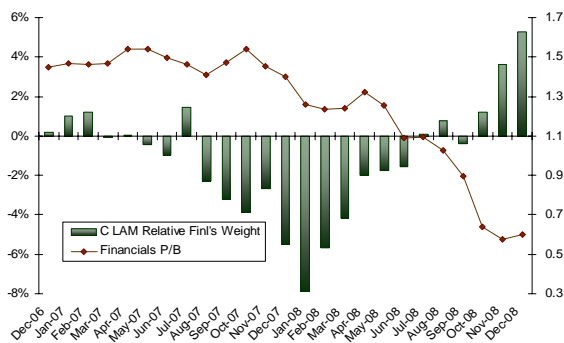
Source: MSCI

As discussed in prior investment strategy letters, in the second half of 2007, we recognized that the global economy was peaking and that the valuation of many cyclical sectors was relatively unattractive. Therefore, we began to shift the portfolio away from the economically sensitive areas of the market including: industrials, consumer cyclicals and financials. The only true cyclical sector that the portfolio was overweight versus the benchmark was the energy sector. The graphs on the next page show the portfolio's relative weights in the energy and financial sectors versus the MSCI-EAFE index over the last two years. The right axis of the energy graph plots the price of oil over the corresponding timeframe while the right axis of the financial chart plots the Price to Book valuation multiple of the banking sector.

**CHESWOLD LANE PORTFOLIO
ENERGY RELATIVE WEIGHT VS OIL \$\$\$**



**CHESWOLD LANE PORTFOLIO
FINANCIAL RELATIVE WEIGHT VS PRICE/BOOK**



Source: Cheswold Lane, MSCI. Financials defined as: banks, insurance companies, asset managers and diversified financials.

The key takeaway from the two charts is that during the spring of 2008, we made a strategic decision, based on valuation and future earnings expectations, to reallocate capital away from the energy sector and into the financial sector. Our view was that we were selling oil and gas stocks at the top of the oil cycle and buying financials, more specifically, European banks and insurance companies towards the bottom of their fundamental cycle and at relatively low valuation multiples. The fundamental call on oil was based on the startlingly bad gasoline demand numbers being released in the spring of 2008, especially in the US. World oil demand growth is a US and emerging market (aka China) phenomena. With the rapidly rising prices at the pump combined with the housing meltdown, US consumers had reached their limits and gasoline demand began to decline by as much as 4% year/year. From a historical perspective, declining US gasoline demand is a very rare event – like during the oil shocks of the 1970’s and 1980’s. The investment rationale for adding capital to the financial sector has been written in prior quarterly letters of 2008 – but the logic was based on very attractive valuations on an absolute and relative basis, a significant amount of underperformance over the prior two years and the belief that the primary fear of the market towards financials, at that time, *inflation*, would mean revert with a fall in commodity prices – which was part of our portfolio’s investment thesis in 2008.

The other major market concern for international financials was occurring in the US – the subprime mortgage crisis. However, by late spring 2008, the subprime crisis was entering its 9th month. Equity investors were now well versed in mortgage market jargon such as the ABX index, CDOs and super senior CDOs. Investment banks, commercial banks and insurance companies were slowly disclosing their positions, writing off ill-conceived investments and replenishing lost capital from sovereign wealth funds. Many market participants believed that the US mortgage crisis would spread to Europe. We disagreed, with the exception of the UK which practiced many of same dodgy non-conforming, high LTV, securitized mortgage practices as the US. At the core, Europeans don’t view their homes as quasi ATMs – their goal is to own the home with no mortgage and their laws generally make mortgages *recourse* loans.

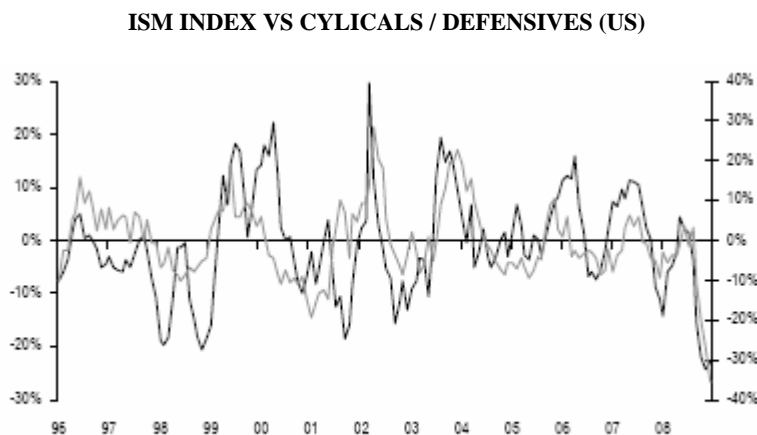
What we failed to fully appreciate was the risk of “financial crisis”. We were inclined to believe that the failure of Bear Stearns could mark, in hindsight, something closer to the bottom of the crisis, rather than what it has turned out to be – the prelude to something far worse. The bankruptcy of Lehman Brothers changed the game and the markets have been in panic ever since. Our goal has been to remain disciplined in our approach while mitigating some of the downside risk by adding to what we consider the strongest financials in the international market

place – these currently include: BNP Paribas, Mizuho Financial, Credit Suisse, Societe Generale and AXA.

Investment Outlook – 2009

Without question, the short run economic outlook is grim. This is because most of the “real” global economy is only now experiencing the full maelstrom of the financial crisis. Towards the end of 2008, consumers around the world reduced their purchases of goods and services and began saving more (deleveraging). Corporations reacted to the change in demand by destocking inventories, deferring capital expenditures, reducing manufacturing capacity and laying off employees. The fear in the marketplace is that this is the start of a wide-scale deflationary feedback loop. Most economists expect the 4th quarter of 2008 and 1st quarter of 2009 to show one of the sharpest periods of economic contraction since WWII – cumulatively, negative 6-7%. Good public policy and global coordination is required to buffer the world economy from this severe downdraft and break the deflationary cycle. The focus must be on repairing the credit markets, instilling asset price stability (especially in housing) and improving consumer confidence.

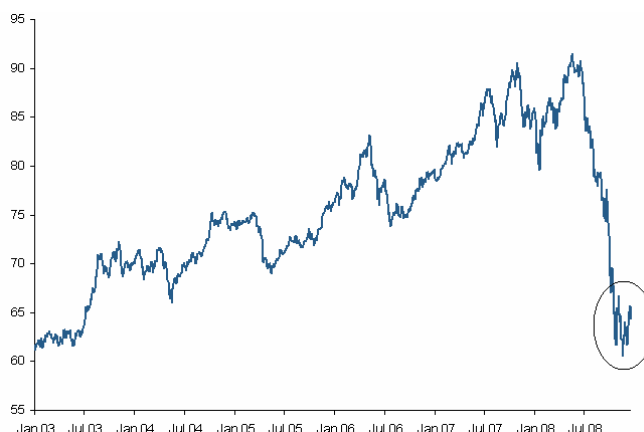
The positive side of the story for investors is that financial markets currently reflect most of the fall out from the financial crisis and are discounting a severe economic scenario, combined with significant liquidity stress. Value stocks, being more economically sensitive, have meaningfully underperformed the market, most notably in the 2nd half of 2008. These include sectors such as: basic materials, energy, industrials and financials; all of which are extremely inexpensive based on absolute valuations and particularly relative to the defensive sectors of the market place – telecom, consumer staples and healthcare. We expect significant sector rotation out of the defensive areas of the global equity markets into more cyclical-oriented names once the market senses the economy is close to bottoming. A good historical economic indicator of this is the ISM Manufacturing Survey in the US, or the equivalent survey in Europe – called the IFO. As you can see from the chart below the correlation between the ISM Survey and the relative performance of cyclical stocks versus defensive stocks is very strong.



Source: JP Morgan

The recent substantial underperformance of cyclical stocks has also been true in the international equity markets.

GLOBAL CYCLICALS VERSUS GLOBAL DEFENSIVES



Source: Credit Suisse

Interestingly, the ISM Manufacturing survey has historically given strong market signals about future stock market returns. More specifically, buying equity market exposure when the ISM is low has historically produced strong future equity returns. This is because many market participants use the survey as a critical economic leading indicator. The most recent ISM survey reading released in early January 2009 was 32.4

ISM MANUFACTURING SURVEY - A MEAN REVERSION TOOL

ISM Range	% of time	average S&P fwd return	
		+6mo	+12mo
25-30	0.1%	21.8%	13.5%
30-35	1.5%	7.8%	15.2%
35-40	4.7%	8.9%	18.5%
40-45	7.4%	0.6%	0.7%
45-50	18.5%	-0.4%	2.4%
50-55	28.7%	0.5%	0.1%
55-60	23.5%	-0.7%	-2.2%
60-65	10.7%	-3.7%	-7.2%
65-70	4.1%	-3.2%	-7.1%
70-75	0.4%	-8.9%	-15.3%
75-80	0.4%	11.4%	13.0%

Source: JP Morgan

Due to the attractive valuations and future earnings momentum, we expect to continue shifting the portfolio towards the more cyclical sectors of the market. After the sharp decline in commodity prices and infrastructure activity, we believe there are very attractive investment opportunities in the energy and basic material sectors. In addition to the financials, these cyclical sectors are currently garnering significant research attention from our portfolio management team. Cheswold Lane's investment opportunity set continues to be quality companies – in terms of ROIC, cash flow generation and modest leverage, trading at attractive valuations.

Admittedly, we are disappointed in our results for 2008; however, we do expect to achieve significantly better relative and absolute performance in 2009-2010 as the global economy and markets recover.

Best regards,

Colleen Quinn Scharpf
Eric Scharpf
Matt Taylor

THE VIEW FROM CHESWOLD LANE...

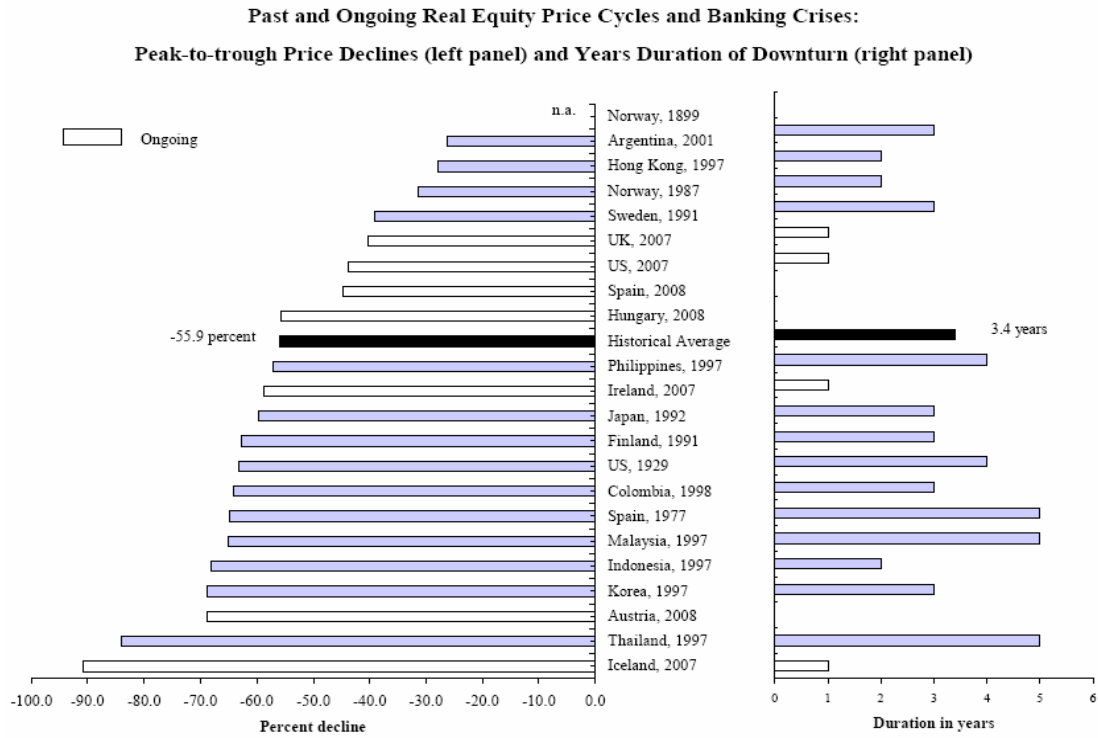
2008: The Year of Financial Crisis

September 15, 2008 is a day most financial market participants will remember for the rest of their lives. It was the day Lehman Brothers filed for bankruptcy. With this action, or as some would say, the *lack of action* by the US Treasury, the US and global economic outlook downshifted from recession to depression. The global credit markets collapsed in shock as it became clear that bondholders and other creditors of the once fabled firm were going to endure significant losses of capital. In hindsight, this was the day the US markets entered a new and darker phase – “financial crisis”.

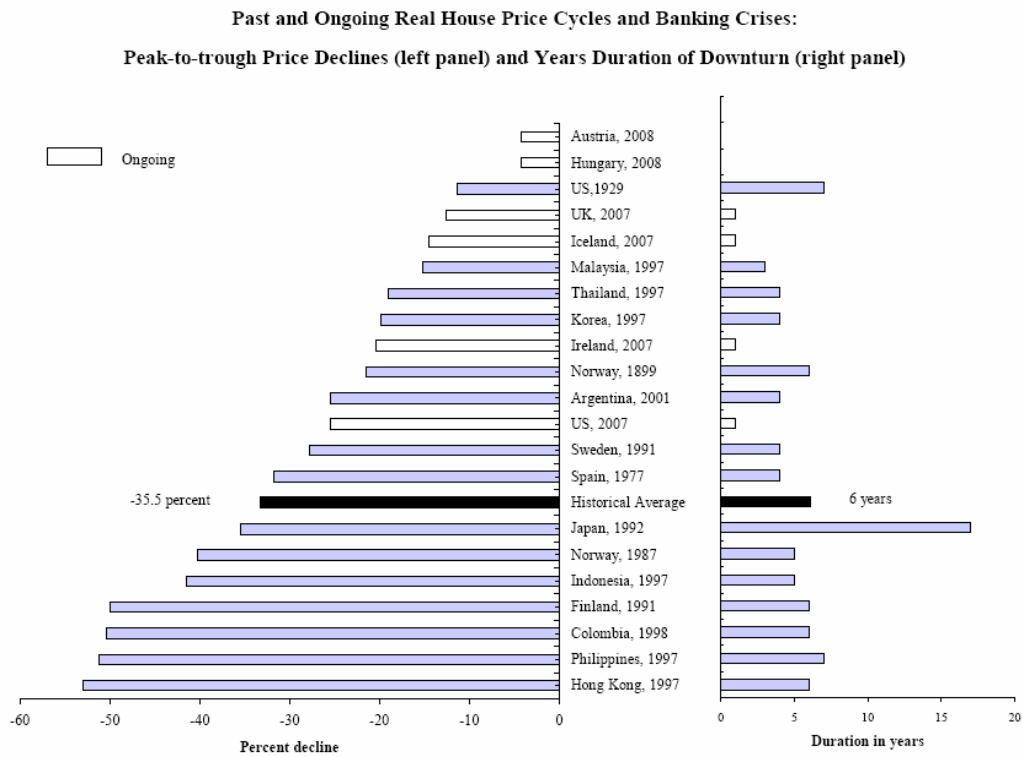
The modern history of financial crises is actually quite limited. Professors Carmen Reinhart of the University of Maryland and Kenneth Rogoff of Harvard University are two experts in the field, having written numerous papers together including a recent release titled, *The Aftermath of Financial Crises*. (<http://www.economics.harvard.edu/faculty/rogoff/files/Aftermath.pdf>) This followed last year’s paper regarding the subprime meltdown, which showed how the US demonstrated similar signs in terms of asset price inflation, rising leverage and large current account deficits, of a country on the verge of financial crisis. With the bankruptcy of Lehman, the US clearly entered a severe financial crisis.

In the *Aftermath of Financial Crisis*, Reinhart and Rogoff compile key macroeconomic data for countries that have experienced severe financial or banking crises in the last 80 years. As you would expect, the data is quite depressing (*no pun intended*). Their conclusion is that there are three central characteristics of financial crises: (1) asset market collapses are deep and prolonged (Graph A+B). (2) output and employment fall significantly (Graph C+D) (3) the real size of government debt tends to expand tremendously. Reinhart and Rogoff give a clear signal that they believe financial crises are relatively uniform in nature and thus, the US and most of the developed world will experience a similar level of decline as past crises.

Graph A

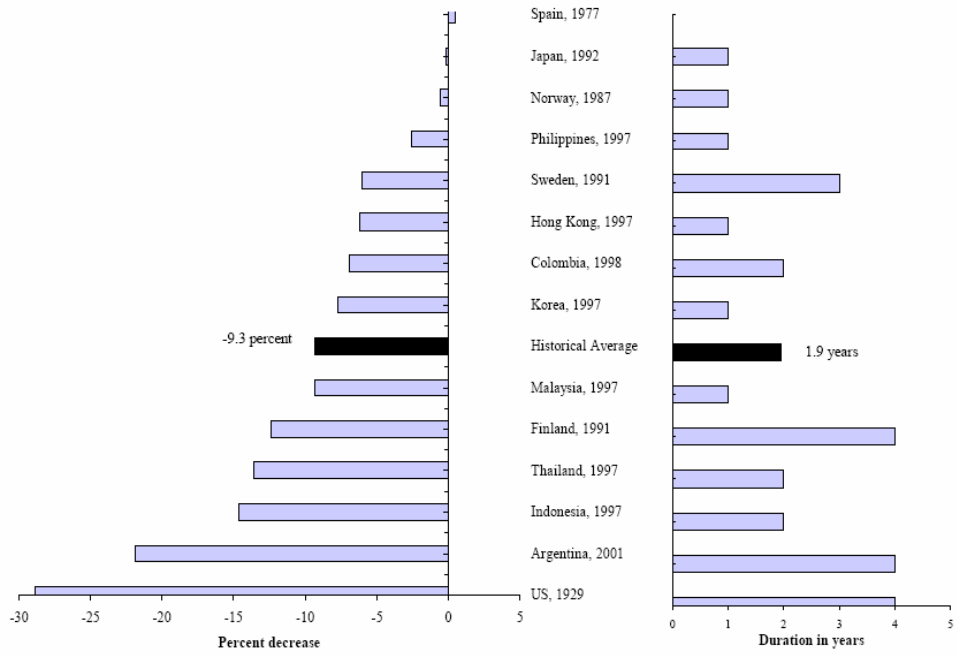


Graph B



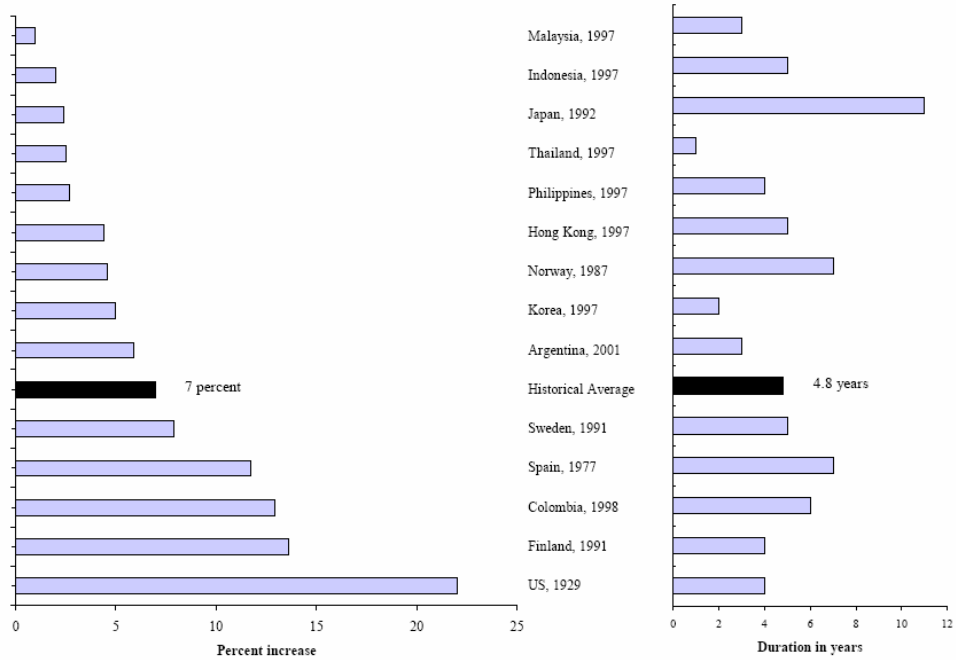
Graph C

Past Real Per Capita GDP Cycles and Banking Crises: Peak-to-trough
Percent Decline in Real GDP (left panel) and Years Duration of Downturn (right panel)



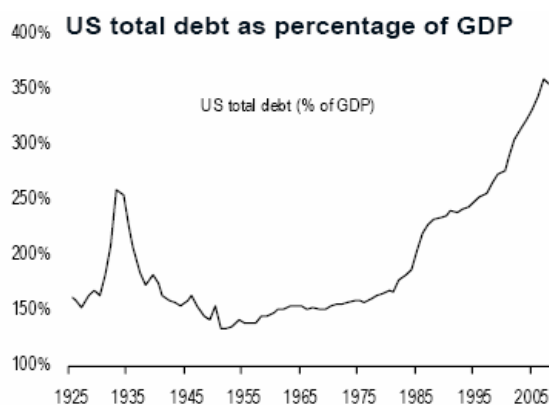
Graph C

Past Unemployment Cycles and Banking Crises: Trough-to-peak
Percent Increase in the Unemployment Rate (left panel) and Years Duration of Downturn (right panel)



After reviewing the data, I posed a few questions to myself: (1) Is the data accurate? Answer: Basically yes, although the authors' statistical methodology takes some liberties with respect to when they "started and ended" the calculations. Most of the data could easily be made to look better or worse with relatively slight changes to the official starting/ending points; (2) Is the data relevant? Answer: In the short term, yes – mainly because it's the only data we have to look at. However, longer term, I think we'll recognize that the speed and severity of this event was driven more by the leverage employed by market participants – investment banks, hedge funds, and private equity firms that were susceptible to deflation, than the actual economic results of the major global economies. I don't believe the US financial crisis today is comparable to the various emerging market crises of the 1980's and 1990's. Even Reinhart and Rogoff's first paper in late 2007 only focused on what they called the "big five" financial crises – (Spain 1977, Norway 1987, Finland 1991, Sweden 1991 and Japan 1992) – because they didn't want to be ridiculed for comparing the US to emerging market countries. I think it's reasonable to question the relevancy of the "big five" in comparison to the current US financial crisis considering three of the five countries were relatively closed, Scandinavian socialist economies with populations of 4, 5 and 8 million people respectively (Norway, Finland, and Sweden). And let's not forget that Spain in the late 1970's was transitioning from dictatorship to democracy after the death of General Franco. (3) As a long-only international value investor, what gives me concern about this paper? Answer: The comparison to the US Depression of 1929. It's an economic scenario not priced into the global equity markets.

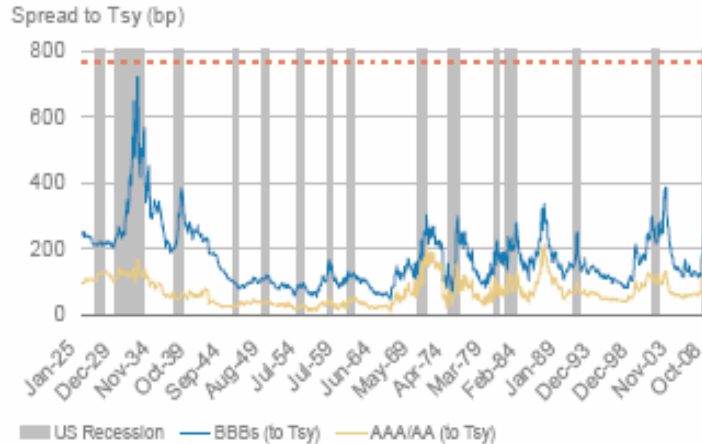
Today there are several similarities to the Depression that will cause the markets considerable consternation as we go through this gut-wrenching global inventory destocking process in the 4th quarter 2008 and 1st quarter 2009. The first similarity is the level of debt and speculation in the markets prior to the Lehman Brothers' bankruptcy. In the 1920's, people used debt to speculate on the stock market. In the last decade, we used debt to speculate in US residential housing. Needless to say, both experiences ended very badly.



Source: Credit Suisse

The second similarity is the weakened state of the global banking system due to the subprime housing and other toxic asset writedowns. The industry is likely to have lost more than 1.5 to 2.0 trillion dollars when this fiasco is finally over. Unfortunately, this is the case before the global banking system endures the impact of the "real" economy in 2009-2010. A comparable signal of market stress in the bond market is credit spreads to treasuries. Today, these spreads are implying a loss cycle as bad, if not worse, than the early 1930's.

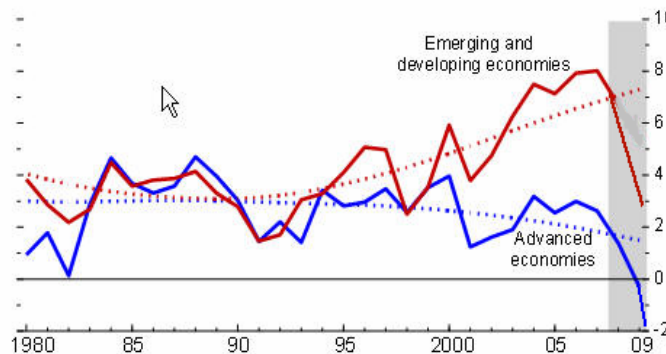
BOND MARKET SPREADS TO TREASURYS



Source: Morgan Stanley

The third similarity is the global nature of today's crisis which is very similar to the Great Depression. This will likely be the first post WWII *global* recession – certainly for the developed economies (OECD). We'll have to wait for the emerging market results which are lagging the US, Europe and Japan this cycle.

GLOBAL GDP % ESTIMATES - NO DECOUPLING



Source: Goldman Sachs, Cheswold Lane

Fourth, as was the case in the early 1930's, the world is now dependent upon government policy to re-invigorate the global economy. In the classic macro-economic sense $GDP = C + I + G + \text{net } E$ – Consumption is declining as consumers in the developed economies delever and retrench in fear of potential job loss; Investment is falling as businesses react to lower demand and thus lower capacity utilization; net Exports are improving for oil consuming countries but weakening for large export economies like Japan, Germany and the emerging markets; thus, the burden to reinvigorate the economy is left to Government, who need to increase spending and reduce taxes in order to prevent the private sector from driving the global economy into a deflationary spiral.

Are we headed for the Great Depression II?

The short answer is no. But that's because many financial pundits who throw out the parallels between today and the Great Depression don't actually know how bad the US and international economies performed during that period.

US National Accounts data 1929-1933

real \$bn	GDP	Consumption	Capex	CPI index	S&P EPS
1929	865.2	661.4	91.3	17.2	20.3
1930	790.7	626.1	60.9	16.7	13
1931	739.9	606.9	38.3	15.2	9.1
1932	643.7	553.0	11.5	13.1	6.8
1933	635.5	541.0	17.0	13.2	7.22
Peak-to-trough	-27%	-18%	-81%	-23%	-67%

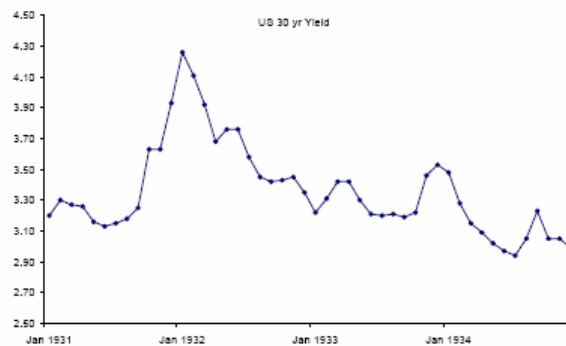
YoY%	GDP	Consumption	Capex	CPI index	S&P EPS
1930	-8.6%	-5.3%	-33.3%	-2.9%	-36%
1931	-6.4%	-3.1%	-37.1%	-9.0%	-30%
1932	-13.0%	-8.9%	-70.0%	-13.8%	-25%
1933	-1.3%	-2.2%	47.8%	0.8%	6%
Average	-7%	-5%	-23%	-6%	-21%
Peak-to-trough	-27%	-18%	-81%	-23%	-67%

Source: Credit Suisse

The magnitude of the contraction in GDP – negative 27% in five years, combined with the level of unemployment – 22% is simply stunning. While I admit, 2008 has had its share of six-sigma events – oil prices, VIX, credit spreads, stock market declines, etc... I can't envision a scenario where the economic contraction of the early 1930's is repeated during this severe economic downturn. It would require a series of policy or systemic events that appear extremely unlikely. Even further discounting most mainstream economists' forecasts for US and European 2008-2009 GDP results, it's difficult to reach a cumulative decline in the two biggest economic blocks of the world of more than negative 7-10%.

The key policy goal is to stop deflation from settling into the major global economies. This is crucial to containing the global contraction to 2009 and not letting it continue into 2010 and 2011. During the 2nd half of 2008, major central banks and other government policy makers took multiple steps to ensure that we don't repeat the 1930's. First and foremost was the level of global coordination between major governments. Examples of this can be seen in the level of cooperation between the major central banks who, in the fall of 2008, orchestrated the world's first major international coordinated interest rate easing policy, as well as valuable new liquidity and foreign exchange swap programs. Cooperation and coordination was not the norm during the Depression when countries acted in a very insular manner with respect to monetary, fiscal and trade policy. Also, with respect to Federal Reserve policy during the Depression, one of the worst mistakes it made was to *raise* interest rates during the economic decline as opposed to cutting them like it has today.

The Fed raised rates in late 1931



Another critically important policy distinction is the amount of fiscal stimulus governments around the world are going to inject into the global economy in the next 18-24 months.

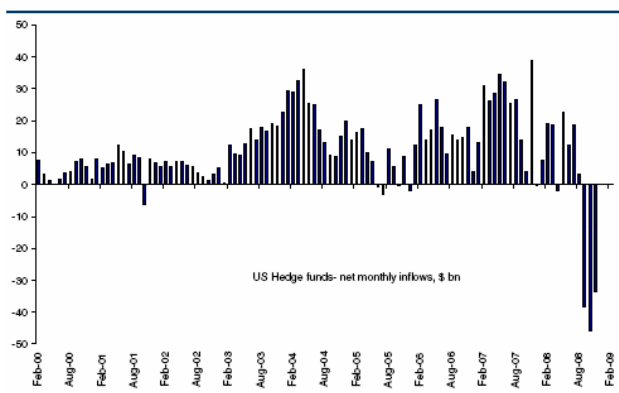
Fiscal stimulus as % of GDP (as announced so far)

Country	Total	US\$bn	% of GDP	Of which infrastructure
US	US\$800bn	800	3.6	50%
Japan	Y10 tn	105	2.0	29%
European Union	€200bn	254	1.5	35-50%
Germany	€31bn	39	1.3	15%
France	€26bn	33	1.3	40%
Italy	€6bn	8	0.4	
Spain	€11bn	14	1.0	70%
Portugal	€2bn	3	1.3	
Netherlands	€6bn	8	1.0	
UK	£20bn	30	1.0	10%
Hungary	HUF 1.4tn	7	5.5	
Sweden	SEK 15bn	2	0.5	
Russia		100	5.8	17%
Australia	A\$ 10bn	7	1.0	
China	RMB 4,000bn	586	8.9	57%
India	Rs.200bn	4	1.5	
Korea	KRW 14 tn	11	1.1	25%
Chile	Ps.1323bn	2	1.5	
Mexico	Ps.78bn	6	0.8	

This government spending is likely to total more than 2.0 trillion dollars over the next 2 years helping to boost economic activity, employment as well as consumer and business confidence. In general, policy makers should be commended for making better decisions regarding today's global recession. One important area to guard against is protectionism, which can depress economic growth via lost productivity, reduced innovation and higher consumer prices.

The bottom line is that I am most concerned about the potential for a multi-year economic downturn because the equity markets are not currently pricing in this scenario. However, I think the comparisons to the Depression are overstated. I think a substantial portion of the decline in asset prices, other than residential housing, is related to the dramatic reduction in liquidity which has occurred coincidentally or causally, due to the massive deleveraging of the financial markets.

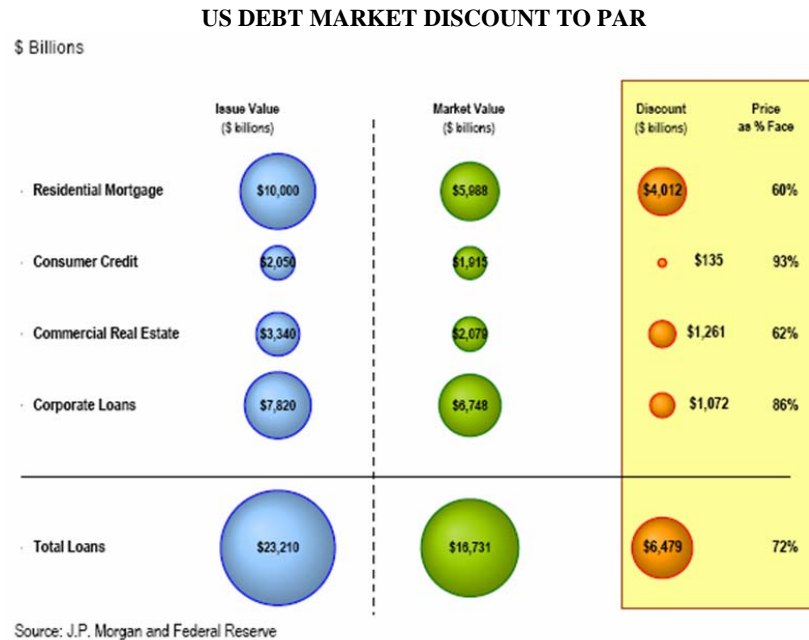
US HEDGE FUNDS – NET MONTHLY FLOWS, \$bn



Source: Trim Tabs, Credit Suisse research

The international fixed income markets never really recovered from the Northern Rock failure. And Bear Stearns' demise triggered the start of a very significant bond market deleveraging process. The average fixed income hedge fund is leveraged 5-6x's, so a 10% move in underlying credit prices has a massive effect on the funds' performance. At the same time, the largest hedge funds in the world, US and European investment banks, which were leveraged almost 30x's,

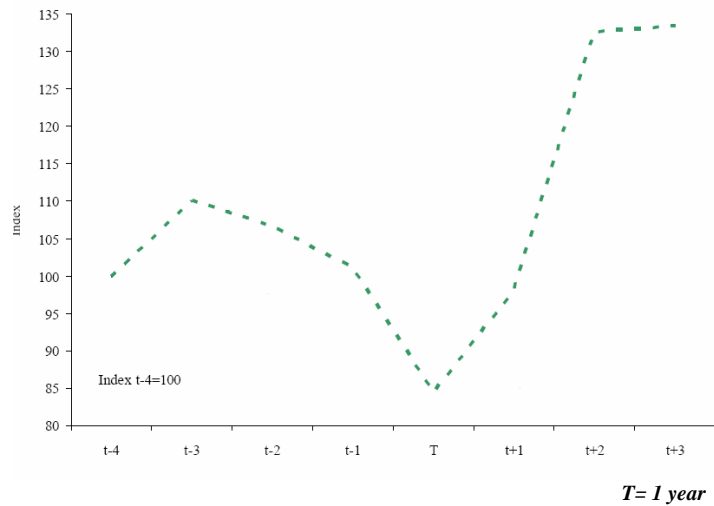
were being forced to delever as well. So, the biggest traders in the market were all long credit using extreme leverage when they realized that the game was over. Once the fixed income/multi strategy/commodity hedge funds started losing significant money (Summer 2008), clients accelerated the redemptions, prime brokers accelerated the hair cuts for collateral to margin and the race to sell assets and deleverage was on; leading to the collapse of the US and European bond markets.



Historically, investment banks and hedge funds provided liquidity to the marketplace (at a price), but in the fall of 2008 – who was going to provide liquidity to them? At its core, investing comes down to matching a willing buyer with a willing seller. The price of the asset moves until the two meet. Unfortunately, for the sellers, more accurately “forced” sellers, in the 2nd half of 2008 the price had to keep moving lower in order to attract a willing buyer. In the case of fixed income hedge funds and investment banks, credit spreads widened to Depression-era levels to attract enough buyers. Equity markets became a casualty of the calamities of the alternatives asset class (hedge funds, private equity, commodities) because when the liquidity dried up and the alternatives managers utilized contractual “gates” to keep assets, the only assets that pension funds, fund of funds and other institutional clients could sell to raise cash were global equities. Also, the rapid decline in equity markets accelerated retail mutual fund redemptions putting more liquidity pressure on the markets.

It will be very interesting to see at the end of 2009 whether the market collapse in the fall 2008 was an example of market efficiency, in the sense of forecasting a deep, Depression-like economic outcome thus justifying the steep decline in asset prices, or whether this was a tremendous transfer of wealth from sellers to buyers. Reinhart and Rogoff did not focus on the returns of the “big five” after incurring the wrath of financial crisis – it was included in their February 2008 paper, *“Is the 2007 US Sub-Prime Financial Crisis So Different? An International Historical.”*

Real Equity Market Returns – “Big Five” Banking Crises



I was not surprised by the results, or that today’s doomsayers fail to mention it either. We’ll just come to our own conclusions.

As always, we appreciate your support and welcome your thoughts and ideas.

Best regards,

Eric Scharpf

Portfolio Manager
Cheswold Lane International High Dividend Strategy
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