

# CHESWOLD LANE ASSET MANAGEMENT, LLC

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## INTERNATIONAL HIGH DIVIDEND STRATEGY

### 2ND QUARTER 2008 INVESTMENT LETTER

Thank you for your continued interest in Cheswold Lane's international value equity strategy. During the 2<sup>nd</sup> quarter 2008, our investment strategy composite returned -3.54% on a gross basis compared with a return of -2.25% 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 -14.1% on a gross basis compared with a decrease of 11% in the MSCI EAFE Index.

#### *Market Review & Outlook – 2Q 2008*

After a strong rally, post the 1<sup>st</sup> quarter liquidity crisis, global equity markets succumbed to growing economic fears, led by accelerating inflation and declining housing prices. Most of the major international market indices ended the quarter near bear market territory. Volatility remains at extremely high levels. The number of stocks enduring 5-10% intra-day swings has grown significantly since the beginning of the year, especially in the financial, consumer discretionary, energy and agriculture sectors. The market has become extremely narrow. Energy and Basic Material, primarily metals, mining and agriculture companies, are the dominant positive sectors while Consumer Discretionary and Financials are the most negatively correlated.

Feeling the debilitating effects of higher transportation, electricity and food costs, consumer confidence and thus, consumer spending has pulled back sharply during the quarter; first in the US, followed by the UK, Continental Europe, Australia and finally, Japan. Business confidence is starting to exhibit the same rolling process only on a six month lag to the consumer. Even emerging market countries are starting to see the affects of the global economic slowdown. The emerging market trade has begun to diverge markedly – those with natural resource based economies versus ones with manufacturing and trade economies. The differences are stark. Within the “BRIC” countries, the stock markets of Brazil and Russia have demonstrated considerable strength while the Indian and Chinese stock markets are down approximately 50% from their 2007 peaks.

The outlook in the developed world has definitely turned grim as most economists are now focused on predicting the severity of the economic downturn. As a forward discounting mechanism, global equity markets are now pricing this negative scenario into stock valuations.

Many cyclical sectors like Industrials, Basic Materials and Energy have low valuation multiples but have peak net margins and returns on equity. Over the next six months, we expect profit margins to begin to weaken in these cyclical areas. The Consumer and Financial sectors are the most attractively valued areas of the market, but they also have the worst fundamental outlook. The direction of oil prices will determine the results of the second half of 2008. Fundamentally, we have seen several cracks in the bullish case for oil including: (1) US gasoline demand is down 2% year-to-date and is likely to end the year down 4%. (2) American miles driven will be down year-over-year, something that has never occurred in the history of the country (3) The US consumer shift to high MPG cars versus low MPG SUVs looks to be a permanent trend (4) Oil demand in all other major OECD regions – Europe and Asia, is declining year-over-year. (5) Oil subsidies have recently been reduced in many Asian countries including China, India, Vietnam, Malaysia, and Indonesia. (6) Early indications are that China's export driven economy is starting to slow.

### ***Portfolio Review – 2<sup>nd</sup> Quarter***

Our portfolio continues to struggle in the first half of 2008. The performance gap can be split into several buckets. The first bucket is related to investment style – value, as opposed to growth. Almost all value discipline investment strategies (P/Earnings, P/Book, Dividend Yield, etc) have underperformed market benchmarks in the last 12 months. This is due to a combination of two things: (1) the market correctly beginning to discount the cyclical peak in the global economy and thus applying lower valuation multiples to the peak earnings of many traditional “value” sectors – i.e., Financials. (2) Momentum investment strategies continue to outperform – and all the earnings and stock momentum are in the Energy, Metals and Agriculture sectors. The second bucket is related to geography – Asia, especially Japan, has outperformed Europe. Our portfolio has more exposure to Europe than Asia, so this has detracted from the portfolio's performance. This is an active decision and we are unlikely to chase geographic performance as the global economies are rolling downward. The third bucket is related to poor stock selection, something we are keenly focused on improving. Our stock selection issues in the quarter were focused in one sector, Financials, and specifically one sector within financials: UK / Irish banks. Our holdings in Barclays, Bank of Ireland, and Irish Life accounted for all of the underperformance in the quarter as these stocks fell over 35%. Performance was aided by our large overweight in Energy, which we began to pare back during the quarter. We sold a significant portion of the portfolio's holding in Statoil, as well as smaller amounts of both ENI and BP. Offsetting a portion of these sales were additions to the oilfield service and refining segments of the Energy sector, including a new Australian holding, Caltex. Other purchases were made in Financials, balancing additions to higher risk European Financials with new positions in Japanese banks, including Mizuho Financial and Nomura Securities. We continue to see opportunities in Financials and expect that the portfolio's weight in this sector will continue to increase over the next 12 months.

Best regards,

Colleen Quinn Scharpf  
Eric Scharpf  
Matt Taylor

## THE VIEW FROM CHESWOLD LANE...

*Financials...Crashing like its 1991...*

Global financial institutions took another leg down during the second quarter, with the steepest part of the drop occurring in the month of June. Credit fears swelled as major US and European investment banks signaled another round of credit write-downs and potential capital raises were coming during the 2<sup>nd</sup> quarter earnings season. Residential housing price declines continued in the US and Europe putting more stress on the banking system. Consumer and business confidence indices fell at an alarming pace during the period. Rumors of Lehman Brothers' demise, *a la* Bear Stearns, made the rounds, even after the company raised \$4 billion of fresh equity capital and replaced its President and CFO.

But the real bearish occurrence during the 2<sup>nd</sup> quarter was the steep acceleration of global inflation expectations. Crude oil moved rapidly once it broke the symbolic \$100 level and ended the quarter above \$140 per barrel. At the same time, agriculture commodity prices rose around the globe including rice, wheat, corn and dairy products. Emerging market governments began hoarding supplies of basic food commodities which exasperated the situation.

Consumers, hit by higher gasoline, electricity, food and interest payments, retrenched, especially in the US, UK, Ireland, Italy, Spain, Japan and Australia. Normally, during this part of the economic cycle, the major central banks begin to ease short term interest rates in order to bolster their slowing economies. However, with inflation heading in the wrong direction, the Federal Reserve, Bank of England and Bank of Japan all had to strike a much more hawkish tone toward future interest rate changes and the European Central Bank actually raised rates 25bps to reinforce its resolve to contain inflation. This was very negative for the global stock markets as it meant that the global economy would have to suffer through a more severe slowdown or even recession before the central banks would lower rates. The balance of economic growth versus inflation containment was now clearly skewed to the latter.

*So, is there any hope for the Financials?*

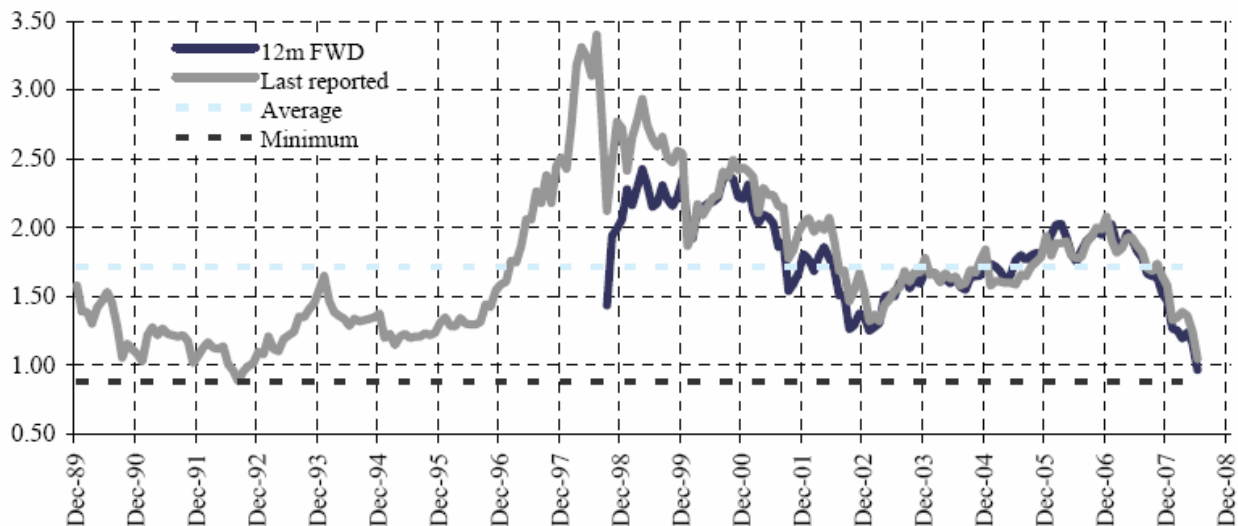
For the US, the answer is most likely, "No" – in the short to intermediate term. The US consumer is significantly over-levered and no longer has the ability to extract monies out of his/her home to fund a lifestyle above current income. The money lent to finance housing in the inland parts of California, the pan handle of Florida, and the deserts outside of Phoenix and Las Vegas is gone. The investment fallacy of US home prices never falling has been broken. Unfortunately, this speculative lending has left the US banking system severely undercapitalized. After multiple unsuccessful capital raises, the private capital markets – Private Equity, Pension Funds and Sovereign Wealth Funds, have effectively given up on this trade. I guess being invited to the private party and still losing 50% of your money in the first 6 months doesn't make you excited to receive the next party invitation. The hangover is definitely not worth it.

The investment conclusion for the US is that consolidation will be required in order to recapitalize the industry. The equities may trade like options before foreign banks are invited to buy and wring significant cost savings out of the system in order to recapitalize these institutions. For the more conservative industry players, who have successfully navigated the obstacles of Sub Prime, Alt A, High LTV Home Equity and Residential Construction & Development, this is

a money manager's once in 25 year opportunity to buy quality banking franchises at severely discounted prices. One could even argue that industry credit spreads will likely remain wider than average over the next 5 years affording higher industry returns on assets during the recapitalization phase of the banking sector.

With respect to Cheswold Lane's portfolio, we are focused on investment opportunities in the European banks. These stocks have been severely punished in the market place – although painted with the same brush as the US banks, the economic circumstances in Europe are more diverse than the US. The single largest difference is related to the mortgage market, which has caused most of the US banking system's losses. Without a doubt, the earnings outlook for European banks is poor, but the investment question is whether the valuation is now pricing in a far more severe recession than will actually occur. With earnings estimates in flux, and capital adequacy being paramount, the market is now focused on Price to Book Value (P/B) multiples as opposed to Price to Earnings (P/E). The European banking sector is currently trading at its 20 year low valuation on a Price to Book basis. In addition, the low valuation multiples are coinciding with trough Returns on Equity (or Book Value). So, you have an investment opportunity to buy stocks in an industry with historically strong returns on equity and growth at 20 year lows of valuation and earnings expectations.

### European Bank Valuation - Price To Book Ratio



Source: KBW

*What's the catch? And there is one for sure!*

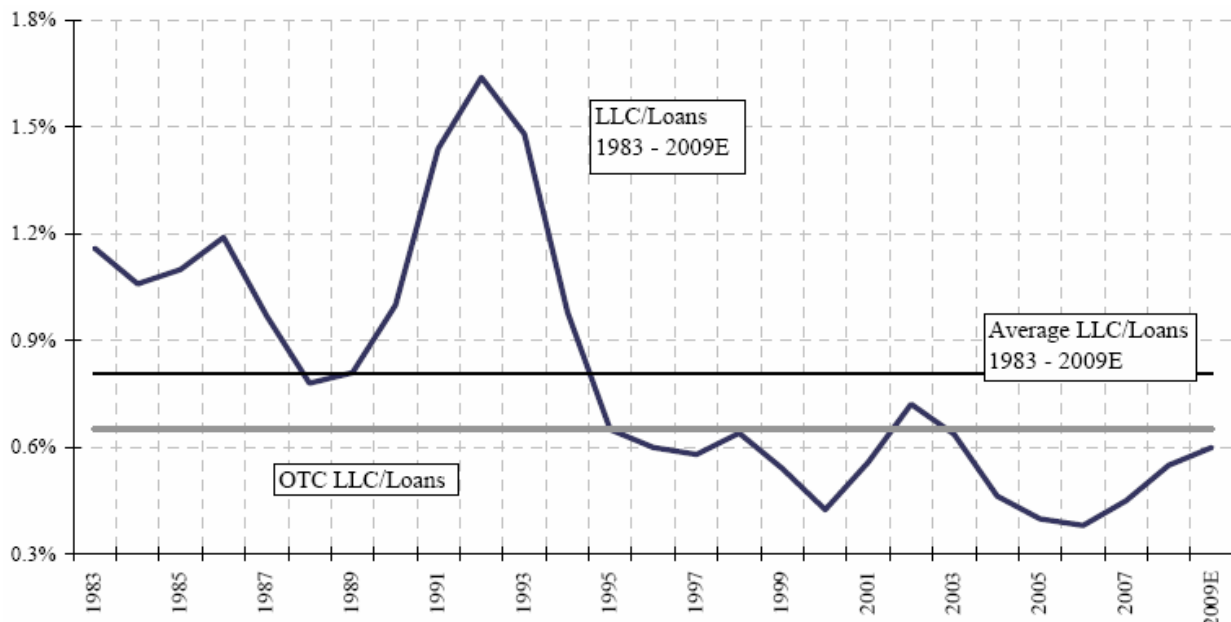
The primary investment controversy is related to future credit losses. While earnings will be negatively affected by higher funding costs driven by the liquidity crisis, lower lending volumes due to the weak economy, and diminished fee income from reduced wealth management and capital markets activity – ultimately, at this level of valuation, it's credit risk that will determine whether investing in the European banking sector will be a rewarding experience or not.

Is the credit loss content of their loan and investment portfolios so severe that the companies will be forced to raise more equity due to poor economic conditions in Europe? This is the critical question for investors. And right now, the market is sending a strong signal that the European

economies are headed for a severe recession, especially the UK, Ireland and Spain – formerly the hottest residential real estate markets in Europe.

The market is grasping for historical data to analyze and run regression models on to predict future credit losses. The problem for investors is that this data is all trending negative right now – consumer confidence, unemployment, GDP growth, inflation, etc. And the positive case is difficult to make until we see the depth of the economic downturn. Today, the market is focused on one metric for determining the outcome of this credit cycle – the decline of residential housing prices. How far they fall, by geography, is the single biggest determinant of credit losses.

### European Banks – Loan Loss Charge-Off as a Percent of Total Loans Outstanding



Source: KBW

As you can see from the chart, Europe has had two or three distinct credit cycles in the last 25 years. The most recent credit cycle peak was in 2002, which from this chart looks pretty mild. Losses were focused on corporate lending books, combined with mild losses in consumer portfolios. Central banks lowered interest rates to support the business sector during the recession and this became the start of the consumer real estate bubble in the US and some parts of Western Europe.

Today, it's clear that the US is in the throes of a consumer led recession much more similar to the experience of 1991-1992. And the markets are pricing in the same type of economic environment for much of Europe. In analyzing potential credit losses, management, regulators, rating agencies, and investors look at *probabilities of default* and *losses given default* for various loan categories: small business, commercial and industrial, residential construction, residential mortgage, commercial mortgage, credit cards, home equity, etc... The asset class that caused the extremely high credit charges in the early 1990's was the US and European commercial office construction and development markets. This cycle, losses in the US are being driven by the residential mortgage market - Sub Prime, Alt A and Option Arms, High LTV Home Equity and Residential Construction and Development Lending. The hot markets of the last 10 years in the US have turned out to have the highest probabilities of default and losses given default. This is

the picture that is being painted on the European banking sector. But is this appropriate? It's too early to know definitively, but the US data is certainly scaring European bank investors and the recent declines in housing prices in the UK, Ireland and Spain are definitely alarming.

However, it is not clear to me how the current situation can result in the level of credit losses seen in the early 1990's in Europe. With the exception of the UK, Ireland and Spain, European residential real estate did not experience a significant boom like California, Arizona, Nevada and Florida. More importantly, even within the European "hot markets" – Sub Prime lending doesn't exist, nor do Option Arms, Negative Amortizing Mortgages and other extreme financing products. Additionally, the boom markets of the US were rife with speculators who drove the prices up with no intention of ever living in the homes. Second home buyers and retirees also played a role in the false sense of "true" demand in the boom areas. This is not the case in the UK and Ireland, where the housing markets have historically been out of balance due to a shortage of housing stock for first time buyers and young families. Finally, the legal recourse has had a tremendous negative impact in the boom and bust of the California market. In California, the lender must choose between going after the borrower's assets or the house that is in default. Generally, the lender chooses the house and the borrower ends up with, effectively, a non-recourse mortgage. This led to increased speculation as financial institutions were, economically speaking, issuing very cheap call options to consumers on California real estate.

To make matters worse for the US financials, the only land available to build all of this boomtown housing was further and further away from major cities and jobs. With gas prices above \$4.00 per gallon, these housing developments have become even more undesirable. The only option is to lower the home prices to fire sale levels in order to compete with the rental market. This becomes the primary driver of the astronomical mortgage *defaults and losses given defaults* in California, Arizona, Nevada and Florida. Again, this picture is being projected onto the European banks, especially those in the UK, Ireland and Spain. I believe the UK, which has a housing and mortgage market most similar to the US, will suffer the most. Spain, which built the most excess capacity, will suffer, but the Spanish banks are some of the most well capitalized institutions on the continent and the legal and moral code of the country is far stronger than the US. As for Ireland, the age and income demographics remain extremely favorable and the conservative nature of its consumers will prove critical to the housing market returning to balance in late 2009 / early 2010.

This doesn't mean that there won't be significant losses incurred by the European banks this credit cycle. In fact, the leading problem for the European banks is that they have already incurred significant losses from their investment and trading portfolios, which held US Sub Prime, Alt A, and high LTV home equity securities as investments. These losses have forced many European banks to raise equity to replace the capital lost from these poor investment decisions.

*What does this mean for Cheswold Lane?*

We continue to research, monitor and invest in the severely depressed European banking sector. The risk/reward proposition is the most compelling opportunity for value managers in the market. The key risk is severe credit deterioration which will lead to further equity capital raisings and thus, dilution for current shareholders. The critical catalyst is a change in inflation expectations; for with reduced inflation the major central banks in Europe will be able to lower interest rates and bolster the consumer and banking system. The opportunity to generate alpha in the European banking market over the next 12-24 months is extremely large. Without a doubt,

there will be bumps along the way, but in the long run this will be a very prosperous road to have traveled. This investment theme fits well with Cheswold Lane's investment philosophy – we buy quality businesses at really good prices!

Thank you for your continued support.

Eric Scharpf  
Portfolio Manager  
Cheswold Lane Asset Management, LLC