

# Red Granite Advisors LLC

## Third Quarter 2008 Commentary

Stock prices declined broadly in the third quarter despite increased potential for lower inflation resulting from falling prices of commodities and energy. The weakness reflected significant stress in the global financial system and a growing realization that credit market turmoil has begun to depress economic growth and corporate earnings. The sharpest decline was realized in September, which we suspect was caused by selling pressure from hedge fund withdrawal requests. The Russell 1000 Growth Index lost 12.33% in the quarter while the Standard & Poor's 500 Index fell 8.37%. Led by financials and consumer-related stocks, Red Granite's Large Cap Growth accounts out-performed both Indices. Year-to-date, Red Granite accounts have also performed significantly better than the Index returns (S&P 500 - 19.28% and Russell 1000 Growth -20.27%) in a challenging environment.

We are concerned the financial crisis is global in nature and worsening. Central banks are being forced to be the life support systems and governments are either nationalizing or fully insuring the debt of ailing banks. Financial institutions around the globe need to recapitalize before future growth can be assured.

Economic growth is slowing and unemployment is rising. US consumers continue to face headwinds in the form of declining real estate values and credit standards are very tight preventing an expansion of credit, the lubricant in the economic engine. A significant lowering of interest rates by the UK and the European Central Bank would be a major positive, in our opinion.

Importantly, we believe the financial market healing process has begun. In our roadmap for recovery, the resumption of economic and US job growth require at least four conditions: stable residential real estate prices; lower food/energy prices; recapitalization of the banking sector; and a re-liquefying of household balance sheets. We have seen modest improvements in some areas, but we see no quick fixes and few options to jumpstart our consumer-led economy in the absence of a strong, smoothly running financial system.

The good news is that inflation and interest rates are likely to fall in the developing recession and lower energy costs are providing a modest lift, at least psychologically. The recently passed \$800 billion federal rescue package will lend support to the financial system and aid some consumers with lower taxes. Although not perfect, the bill is a positive step because it indicates that the government will do all within its power to prevent a systemic catastrophe. Time and additional stimulus will likely be needed to stabilize employment and housing.

The portfolio was in a good position to defend against the turbulent environment, so there were few changes in the quarter. We modestly increased exposure to energy stocks and trimmed positions in health care and technology. Our emphasis remains on managing risk by holding high cash reserves and owning high-quality, well-financed companies that can raise capital, if needed, and capture market share from weaker competitors.

We are in a period when flows of funds among asset classes can create an overpowering disconnection between company prospects and market action. While unsettling, rapidly falling stock prices can provide opportunities for long-term investors to own good businesses at attractive valuations. In fact, we have identified a number of "companies of interest" and are patiently waiting for targeted price points. We may not find the absolute bottom when we buy, but lower valuations should mitigate the downside risks.

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