



Arbor Capital Management

Investment Overview

The economic contraction is upon us, though it still remains to be seen if we actually fulfill the technical definition of recession of two consecutive quarters of negative GDP growth. In any case by the time such a pronouncement is made, the recovery will have already have started in our view. The next month or two will likely bring the worst economic statistics of the current business cycle. It is possible that there may be one or two surprises left, but we expect most will be in line with expectations. The economic statistic releases will probably be at their worst over the next 1-2 months. We think security prices have nearly fully discounted the prospect of a recession.

Banking Crisis. As anyone who ever worked at a bank will tell you, banks are among the most tightly regulated companies on the planet. There is an army of agencies that audit internal controls, standards and operations at least yearly. It is impossible for us to conjure up how the sub-prime problems could have gone undetected by tens of thousands of auditors. The Federal Reserve under Alan Greenspan and others responsible for their oversight clearly dropped the ball. Mr. Greenspan wanted to encourage mortgage lending as a means of stimulating economic activity which worked better than expected. Hence, the housing bubble was formed and now the economy has to deal with the hangover.

Treasury Secretary Paulson recently laid out a blue print for sweeping change of the entire system of financial market regulation. From our perspective inadequate regulations are not the problem at all. Rather, enforcement of those that are already on the books was lax. One of the recommendations of Secretary Paulson's proposal that we favor is the consolidation of the alphabet soup of bank (and credit union) regulatory agencies. It makes a great deal of sense to us to centralize credit underwriting standards and bank operations oversight. Most of these agencies were created under conditions that have not applied to the current state of the economy for a generation or more. Currently, some are little more than playgrounds of special interest groups. We can think of no logical reason that sound loan standards ought to be enforced in one region of the country and suspended in another.

This would enable better coordination between the Fed, Treasury and the Securities and Exchange Commission.

Given the volume of loan portfolio write downs and the fire-sale pricing of mortgage backed securities, we think the bulk of the negative impact of the mortgage problem is past. What remains, however, are a number of lingering problems, challenges and opportunities that are likely to persist for years. For example:

1. The nominal value of loan write-downs at better run banks is probably overstated. There is little if any incentive for bankers to avoid charging off loans or losses in this climate. Bankers do, however, have every incentive to avoid criticism, so, they can be expected to be very aggressive in posting loan losses.
2. Recoveries on defaults usually approach 60-70 cents on the dollar. The stage is being set for extraordinary earnings comparisons in future years. This will create a buying opportunity for bank shares. We would not be surprised if in a few years that we are reading headlines about the miraculous recovery of the American banking system.
3. There is an indeterminate value of unsold real estate that is deeply under water. Some will be paid off while others will be forced to default. Our best guess is that it will take a period on the order of magnitude of 2-3 additional years for this to resolve itself. The ultimate economic cost can not be

forecast but as long as the liquidation process is orderly this should remain primarily a regional phenomenon.

Help is on the way. The Fed has aggressively cut short term rates over the past 9 months successively lowering the target Fed Funds rate from 5.25% to 2.25%. The full impact of the first rate cut last August is only now being felt. Each cut will create an additional wave of stimulus that will wash over the economy between now and the start of next year regardless of what else happens. We think the monetary remedies are in place and well positioned to stimulate activity at exactly the point in the business cycle where the economy is likely to be at its weakest. The fiscal stimulus of the tax rebate checks to be mailed out next month should also serve as a jolt to help jumpstart activity. Lower rates will permit ARM resets to be better than previously anticipated helping some weather their mortgage storm. This is why we are optimistic that any recession we have, if we have one, will be short lived.

Our fixed income strategy remains defensive. Rates of Treasuries and US Government Agencies are near historic lows and the possibility of inflation driving rates significantly higher is strong enough to raise caution. Maturities of new purchases are expected to be shorter than 7 years with underlying credits of AA or better.

Our equity strategy at this time is to remain disciplined. We think that stocks will rally strongly once it becomes apparent that the economy has bottomed. Our focus remains on Energy and Technology. It is expected that health care will be a prominent political football this autumn so we are moderately reducing our weight in the group. We will be seeking entry points to high quality banks that have been unfairly tainted by the sub-prime mess. Select early cycle shares may be purchased, should their valuations reach our thresholds.

We submitted our investment performance to Informa PSN, the largest investment manager database. Our Large Cap Growth composite ranked in the top 4% of managers for return and the top 1% for lowest risk, out of 240 managers in the database.

Gerald T. Cole, CFA
Chief Investment Officer

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