



ARBOR CAPITAL MANAGEMENT

The year of 2008 was probably the most challenging since the Great Depression. Virtually every sector and asset class suffered significant declines. While we take no pleasure in reporting negative performance, you should know that Arbor Capital Management ranks in the *top one percent* of Large Cap Growth Managers for 2008 according to PSN, the largest investment management data base. Our performance also ranks in the *top one percent* for the quarter, three years, five years, seven years and ten year periods. We also rank in the *top one percent* for lowest risk for the past three, five, seven and ten year periods. The 2008 median performance for the over 250 managers in the Large Cap Growth Universe was negative 38.37%. The S&P 500 for 2008 was negative 37.00%. We hope our performance during these difficult times reconfirms your judgment in hiring us, and hope you will mention us to your friends whose experience in 2008 was less successful.

This year is beginning on a somber economic note. The recession is in full swing. We still expect that the worst year to year comparisons of most statistics will occur toward the end of the current calendar quarter. Later this year we expect the general economy will gradually regain its feet. However, any recovery that we experience this year is expected to be muted. We expect GDP growth to be negative the first half and slightly positive the second half. The total year's GDP growth is likely to be near zero in our opinion.

We think that we are in the teeth of the economic storm - right now. Most, if not all, of the economic time series that we follow continue to deteriorate and are likely to post their worst year to year comparisons in the current quarter. Many are approaching the lows of the 2001 recession and the steepness of their declines suggests that many economic statistics will approach the extreme levels of the 1980-82 recessions. In light of the news of auto sales plunging 36% year over year this past December, it comes as no great shock that the manufacturing segment is under duress. The purchasing manager's index declined to 32.4% for the month of December (any number below 50% indicates contraction). The service sector did comparatively better with a December number of 40.6%, which is still quite weak. Capacity Utilization continues to fall as does Employment and Industrial Production. Unemployment may surpass 10%. Home prices are still seeking a bottom. Consumers are cutting back. Consumer confidence is near a 30 year low. Many State and municipal governments across the country are projecting expanding deficits for next fiscal year and probably beyond. This is being felt in reduced confidence in several municipal credits.

The good news is that Congress recognizes the need for fiscal stimulus and the Fed has been aggressively pumping money into the financial system. It is uncertain what form a Federal stimulus plan will take. However, the Obama plan as it is currently written expects to spend a total of \$800 billion. We think that the combination of stimuli will be helpful in getting the economy moving forward by year-end but will have little lasting effect. The

programs being suggested are FDR-style public works programs, one time tax rebates and outright handouts that do little if anything to create lasting jobs. What this means is that we will get a one time boost but little or no increase in productive capacity or human capital to generate the tax revenue to repay the debt that the USA is about to incur. In contrast, a 5 month tax holiday would cost exactly the same amount but would provide a more immediate impact and would allow taxpayers the freedom to choose how to spend or invest the money. Additional government overhead would be zero. Either way, the debt will still need to be repaid which will be a drag on future growth.

Growth is critical to taming the national debt. Since 1945, federal government receipts have held remarkably stable near 18.1% of GDP regardless of wide marginal tax rate swings (Source: US Department of Commerce Bureau of Economic Analysis and US Department of Treasury). This means policy makers ought to focus on growing the economy as the best way to raise revenue and create new jobs. Unfortunately, neither Congress nor the President-elect seems to be so inclined.

As the economy contracts some productive capacity is lost or at least shuttered. With credit markets being as tight as they are, some companies will elect not to undertake capital improvement projects or may have difficulty finding funds to re-start facilities. Most industrial companies are cutting costs and capital spending.

Once the economy regains its footing, we may experience shortages because it takes both time and money to restart operations. This is particularly true with commodities where resurgence in demand from Asia will add to the problem. This will probably lead to cost-push inflation that is greater than nominal economic growth (stagflation). We last had a period of protracted stagflation during the 1970's. During that period growth was slow, unemployment remained elevated, standards of living declined, inflation skyrocketed and interest rates surpassed 20%. It is premature to suggest that the current business cycle will be as severe, however, a defensive posture toward our fixed income selections appears warranted. We advocate keeping average maturities short and credit quality relatively high. Corporates and Agencies are preferred over Treasuries at this time because the flight to safety has made Treasuries relatively expensive. Municipal bonds are feeling the negative impact of several Bond insurers having suffered credit downgrades themselves. Our focus in Municipals is on General Obligations and issues such as school districts that enjoy multiple layers of funding protection and tax authority. Even in times of extreme difficulty, these obligations must be met or funded.

Stocks are acting about as we expected. The recent sell-off appears to be setting the stage for a re-test of the 11/21/2008 low of the S&P 500 (741.02). Selling pressure over the next few weeks can build substantially. We will be using this weakness to start accumulating stocks gradually. There are a large number of excellent companies whose share prices already seem to be discounting the worst. We feel that the majority of the stocks that we select will be priced much higher in 2-3 years and that the precise low point in share prices will be nearly impossible to spot. We expect to eventually own a larger number of names than we have in the past for two reasons:

- 1.) The pressures on the economy and financial system have increased idiosyncratic (company specific) risk in our view. Because today's economic crisis is without precedent, many companies are facing challenges that they never dreamed that they would have to face. This means that some companies may become illiquid despite an otherwise thriving business. Therefore, in some cases where we would have purchased only one company in an industry, we may now purchase two or three.
- 2.) There are so many great long term values available that we feel compelled to seek participation in more companies.

We will be sticking with our discipline of purchasing some of the best known companies in the world that are growing more rapidly than the average company and have excellent credit characteristics. There will also be a number of themes that will be interwoven in our selections.

- 1.) Early Cycle. These are companies whose earnings accelerate first in an economic recovery. These include basic materials, transportation and energy.

- 2.) Financials. The Federal Government has clearly adopted a too big to fail doctrine. Surviving institutions will show extraordinary profit gains.
- 3.) Staples. Soaps, Utilities, Health Care
- 4.) Dividends. Many stocks have generous dividend yields and reasonable growth prospects.
- 5.) Share Repurchases / Insider Buying. One of the best indicators that things in a company are going well is a substantial share repurchase or large personal purchase by an officer or director.
- 6.) Outstanding balance sheets. Given today's climate, can we be too careful?

We have always viewed the investment process as one of making decisions under conditions of uncertainty. This is (hopefully) the most interesting market environment of our lifetimes. As investors we can still make money because the economy is a dynamic entity. As the economy changes different companies and sectors will assume leadership while others will fade in relative importance. Over relatively short time horizons human nature is such that emotional response to change often drives share prices to extreme levels – in either direction. In every instance in the past rational pricing eventually reasserted itself. In this context, change is the kernel of opportunity because it creates turmoil that leads to mis-priced securities, many of which we can successfully identify. Once the chaos subsides we expect markets to begin to anticipate a return to a more stable economy 6-9 months hence. We think our years of linking macro-economic analysis with stock selection will put us in excellent position to add value to our clients' portfolios through industry and company selection.

Sincerely,

Gerald T. Cole, CFA
Managing Director

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