

Johnston Asset Management

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As We See It.....

We normally like our quarterly letters to cover what happened in the past three months and what our outlook is for the market and your portfolios. In this case, though, the most interesting events occurred immediately after the quarter ended!

We had been in what felt like a fairly typical bear market. Softening US and global economies were widely expected as a result of the popping of the credit bubble. These would have a negative impact on corporate earnings, and stocks started to discount that impact in October of 2007. Through nine months we observed a difficult environment, but not an unusual one, given all the shocks the economy had endured. Not knowing when the bottom would come, we stayed away from financial stocks but otherwise stayed invested. We saw an abrupt drop in the market a few days before the end of the third quarter, but the market seemed to find its footing and rallied into the end of the month to end on a high note.

Then panic set in. Already down 20% on the year, the S&P 500 precipitously lost another 22% of its value between October 1st and October 10th. Bank failures, a money market freeze and fears about a deeper than anticipated recession trumped the "good" news of massive, coordinated, multinational government financial rescue plans. Energy prices collapsed. Faith in free market capitalism was wavering. It had all the markings of a classic market capitulation.

Our portfolios have not weathered this storm without some damage, and it is not clear that the barometer is rising yet. Nonetheless, our overweight position in healthcare eventually proved defensive and should provide some growth in just about any economic environment. Technology stocks are more cyclical, and they have been under severe pressure, trading at prices and multiples of earnings that we have not seen since 2004. Of course, many of them rely on the financial services industry for a large part of their revenue, and we cannot expect much in the way of additional spending from that sector for awhile yet. We remain invested there because



Richard Johnston
President

we believe that improving the collection, processing, and application of data is a long term trend that has plenty of life still.

Banks, investment banks, and insurance underwriters have borne the brunt of this hurricane. Fortunately, the portfolios are significantly under-weight in financials. We have not shunned these companies; in fact we have

spent much of the last six months looking for bargains in the sector. We never found one. However, we believe we will eventually find a durable, competitively-advantaged franchise that will meet our growth criteria for a multi-year period.

There are great opportunities in equities. We do see the ground work being laid for an economic and market recovery. The banking system is thawing. Energy prices are falling rapidly, freeing up some dollars for consumer spending. Capital markets are freeing up slightly, and high quality franchises are attracting significant investment from the likes of Warren Buffett.

Why Not Go to Cash?

We have been reading about investors selling all their stocks and bonds and going to cash. We have also been fielding questions from clients on this topic. Granted, given the market's volatility, it is tempting, but timing these decisions is nearly impossible. Earlier this year we attended a conference where Professor Peter Ricchiuti of Tulane University reminded us that over the last 30 years the S&P 500 returned 11% per year on average. If you missed the best 30 months over that period your return would have dropped to 3% per year! **The message: stay invested or the odds of missing the best returns drop dramatically.**

We remain grateful for your business and always welcome your referrals.