

Campbell Capital Management

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Dear Money Management Client:

The subprime mortgage meltdown is this quarter's news story. It goes like this: over the years, and particularly the most recent ones, some \$1.3 trillion dollars have been loaned to people with poor credit histories. Those subprime loans as they are known, enabled borrowers to purchase homes they would have otherwise been unable to purchase. But that's not all, to make it really interesting the lenders in many cases required no money down and no documentation. When interest rates began rising during the past year many borrowers simply walked away from their mortgage obligations, sending 25 or more subprime lenders into a tailspin. When news of the huge losses reached Wall Street in late February, investors panicked and a selling spree ensued.

We wrote in January that the housing market was too important and in too much trouble not to be a problem this year. It's now easier to see that there were more houses built and sold than there were eligible buyers. The easy money from subprime lenders created an inflationary home price environment and encouraged speculation. The resulting glut of inventory set the stage for an inevitable reversal of fortunes. And now we wait to see if the subprime market is isolated and contained or the beginning of a bigger concern.

The bigger concern involves what Bill Gross refers to as the "Plankton Theory". That's where plankton, a microscopic organism in the sea, represent the first step in the food chain just like subprime borrowers are first time home buyers. Without plankton no other sea life could survive and without easy credit, there would be far fewer first time home buyers. The health of the sea depends on plankton and the health of the housing market depends on subprime loans, or so goes the concern.

The stock markets have actually recovered nicely from the February selling spree and it's likely most of the damage is done. But the February exercise did show us liquidity is the most important component of market health and world equity markets are far more coordinated in price movement than anyone would like. Sound dividend paying stocks with solid cash flow are more important than ever for making good returns.

We remain committed to a conservative investment philosophy, which emphasizes the preservation of capital. If you have any questions or would like to discuss your portfolio, please do not hesitate to call.

Very truly yours,

Clay Campbell