LUMBARD INVESTMENT COUNSELING

INSIGHT

Nasdaq Composite 2,652* Dow Jones Industrials 13,264 * 30 year U.S. Treasury Bond 4.46%

BANANAS

The U.S. economy has entered a recession.

Recessions are such common events that politicians used to try to time the downturns to coincide with the first year of every four-year presidential term. Yet the word still seems to send shivers down the spines of millions. When Gerald Ford asked Herb Stein, his chief economic adviser, to avoid the "R" word, Stein told a group of reporters "From now on, I won't use the word recession.' I'll say 'banana.' When I say banana, think 'recession'. I think we must be wary of the risks of a banana."

Well, we don't have to be wary any more. Pretty soon we'll be looking ahead to the recovery, and wondering when the stock market will take off. Yet it would be a bad idea to jump the gun. American consumers have been supporting the world economy for more than a decade, and the entire planet is going to feel the pain of our newfound frugality.

There is no shortage of observers who think that China and the rest of Asia will continue to sail along without a care in the world, but these pundits have short memories. The Asian financial crisis was *less than ten years ago,* and it's still a searing memory for that continent's policymakers and consumers. Latin America? In a few months you'll begin to hear the old chestnut "when the U.S. gets a cold, Latin America catches pneumonia."

"*The Fed is pushing on a string!*" The pundits will trot that one out later this year, suggesting that the Fed's efforts to stimulate the economy by pushing down interest rates aren't working and can't work. Eventually they always do.

> " In March 2001—the month the last recession began—95% of American economists believed that there wouldn't be a recession."
>
> -- The New York Times

That declining-interest-rate environment is a reason to put your money in bonds rather than cash. Money-market funds and other short-term investments will hold their value, but their yields will prove to be very disappointing—declining to less than 1%. For many months we've been telling you to buy long-term U.S. Treasury bonds, which offer an ideal combination of interest, appreciation, and bombproof security.

Warren Buffett used to say that it makes little sense for investors to feel depressed about a declining stock market, because it's a wonderful opportunity to buy. We're *hoping* for a significant decline in the stock markets of other countries, because we'd like to make our first equity investments of 2008 in a foreign market. Asia really *is* ready to declare its independence from American consumers, and if those overheated markets drop to fair value—or, hopefully, below fair value—we will buy with enthusiasm.

Then we'll turn to the U.S. markets, trading in our drug stocks, electric utilities, and the like to load up stocks that are sensitive to economic growth. The falling dollar is spawning a resurgence in American manufacturing, and it will be good to see us reclaim a role in this sector (machinery, technology,

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BANANAS

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durable goods) that is so often an engine of innovation and increasing productivity.

If you can come through a bear market with most of your assets intact, and then buy with enthusiasm—two separate and difficult things—you will leap far ahead of the market averages and your peers. We're moving ahead.

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The earth's crust holds enormous reserves of uranium. Scientists tell us that there was even a naturally-occurring nuclear reaction that lasted for hundreds of thousands of years in Gabon, Africa. Uranium is about as common as molybdenum—Australia has huge unexploited reserves—but a large nuclear reactor requires only about 50,000 pounds of the stuff (purified or "enriched" to 4% U-235) per year.

Don't even think about betting on a shortage.

LOOKING BACK

The decline in real estate prices that we long expected is well under way, and home construction is indeed declining toward a rate of a million a year—down more than 50% from its peak. U.S. Treasury bonds are appreciating, the dollar has declined further, and our steady-Eddie stocks have performed as well as we had hoped. There is no war with Iran on the horizon, and Americans are beginning to understand that Iraq's Shia are not evil, after all. The American press owes them a lot more than an apology.

The price of oil, however, has moved higher. After all the wailing about $3 gasoline, Americans went right out and bought bigger, more-powerful vehicles; **55%** of the light vehicles sold in October were trucks, few of which could be called "light" vehicles . . . . Everybody wants to blame China, but last year *our* oil consumption went up by 500,000 barrels a day, while China's went up just 400,000 barrels.

On the supply side, the development of alternative energy has proceeded slowly, because its proponents still carry scars from the last oil-price collapse just ten years ago. Alternatives are coming anyway, because today's fuel prices are high enough to make all sorts of things possible. In fact, if we were to hold the price of oil at $90 per barrel for long enough, world oil consumption would almost disappear. At that price oil is more expensive than any alternative, unless you're counting aged Scotch whiskey. *Texas Tea is only indispensable when it's cheap.*

Given enough time, we can shift *all* of the world's vehicles to electric power, recharged by nuclear, coal, solar, and wind. Or we can shift *all* of the world's vehicles to diesel fuel derived from coal. Or we can shift most of them to biodiesel, and most of the rest to natural gas. Even ethanol might have a role; switchgrass-based ethanol for the general public, and corn-based moonshine for lobbyists and corn-belt congressmen . . . .

Lumbard Investment Counseling's advisory board, in 1990

The Earth is running out of corn!

If oil is so darn precious, why were they giving the stuff away less than ten years ago? At the time, the Congress failed to protect the alternative energy industries by holding the price of gasoline and other fuels at a reasonable level. Conservation programs were set aside, and alternative-energy companies went bankrupt by the hundreds. We're about to make the same mistake again.

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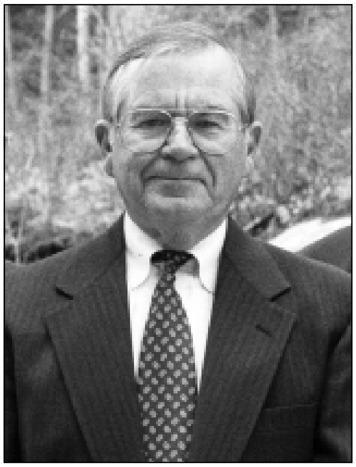

John Convery Jr., CFA

At the peak of the real estate boom a three-bedroom home in our golf community in Naples, Florida sold for $650,000. A month ago a very similar home sold for $300,000. Either one of those prices might have been an outlier that does not accurately reflect the market, but they are not far out of line with other listings and transactions in the area. People are only just beginning to understand how bad the Florida real estate market is, and how long it's going to take to work it out.

Florida's housing market is an extreme example of the real estate contraction that is underway in the nation as a whole. It's a contraction that flies in the face of all the assertions heard in recent years that real estate always goes up in value, and it comes very close on the heels of the bursting of the last real estate bubble in the 1990s. We happened to be in Rhode Island at the time, and while we enjoyed the rising prices of the 80s we eventually sold our home—after 12 years—at roughly our cost.

The bursting of this bubble is a dramatic event, but it's not a large enough event to cause a recession. Our economy will always continue to grow unless somebody does something to stop it. In the past it's always been the Federal Reserve that has played that role, reducing the money supply, raising interest rates, and causing a credit crunch to rein in inflation and curb excessive speculation.

The Fed has been on the sidelines this time, but we have a credit crunch nevertheless. This one was cooked up by the geniuses of Wall Street, who used a wide array of complex new financial products, gimmicks, and salesmanship to bring a tidal wave of new money to the mortgage markets. By the time they were done there seemed to be a bottomless well of money available for any sort of consumer loan or crazy financial gamble. When the game unraveled the money swiftly dried up, and the result is a classic credit crunch.

Recessions usually follow credit crunches by about six months, and we've probably been in one for several weeks now. They are painful but necessary, in that they give us a chance to turn over the rocks and discover underneath them the crazy things that financial institutions and investors have been doing. In this case it wasn't just Wall Street, but also the commercial banks, the mortgage companies, and even homeowners who falsified loan documents or took on foolish risks.

On the plus side, we can all stop worrying about the shortage of affordable housing. It's probably not a coincidence that in Florida the first government-financed, overpriced, "affordable housing" units are just now hitting a disinterested market. That's a good indicator to keep in mind for the next housing bubble, and it's a good reminder of the futility of government responses to perceived crisis.

Affordable housing, at last!

From here, we can look forward to buying opportunities. Over the years it seems that our greatest successes have come at times when investors are frightened. They often throw out the baby with the bath water, irrationally selling the stocks of good companies at unreasonably low prices because they have decided to sell everything. It's impossible to predict where the best bargains will be, but we'll be watching and waiting.

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MILES AND MILES

Solel, a privately-held Israeli company, is building a huge, "thermal" (mirrors and steam, rather than scarce silicon and expensive photovoltaic panels) solar-power plant in the Mojave Desert, east of Los Angeles. The installation will produce 553 megawatts—the equivalent of some coal and nuclear plants—and the power will cost a reasonable 10 cents per kilowatt-hour (before counting the costs of transmission and distribution). The bad news is that it's going to take an awful lot of land to keep the Jacuzzis running in Beverly Hills. Solel's rows of parabolic trough solar collectors will stretch over NINE SQUARE MILES.

John Lumbard, CFA

WEALTH AND LEVERAGE

According to the Federal Reserve, household financial savings stand at a record $29.1 trillion. This number is the sum of all household *financial* assets (*not* homes and real estate), minus *all* debts (including mortgages). By comparison, at the end of 2006 Japan had $9.8 trillion, the UK had $4.8 trillion, Germany had $3.2 trillion, and France had just $2.6 trillion in household financial savings. Even now, after a year in which the dollar declined quite a bit, the US has greater financial savings than all of those nations combined.

How can this be, at a time when we've been running a negative savings rate for years? The answer is that the awful savings-rate statistics you've seen in the newspaper do not include capital gains, on common stocks or anything else.

Americans borrowed heavily to achieve a good part of this surge in wealth, and that means that we took on a lot of risk. The guy down the street who put down $5,000 to buy a $500,000 house lost 100% of his investment when the value of the home declined by $5,000. Now he's down more than ten times that sum, and he's in exactly the same kind of trouble that sank many of the hedge funds who borrowed to increase their returns.

Long economic booms always breed financial carelessness and excessive risk-taking. We are a wealthy nation with the means to take care of all our citizens, but we can't afford to shield them from the effects of poor judgment. If we rescue those who made poor choices or lived beyond their means, they will continue to make poor choices in the future.

Innovation, productivity, and entrepreneurialism are responsible for most of the wealth—and most of the poverty reduction—in the world. One of the dangers of a recession is that compassion will cause us to enact laws that derail these great locomotives.

Many people find it difficult to remember how Americans actually lived several decades ago. The working poor did not get indoor plumbing and electric lighting because of the way the economic pie was sliced; they won these advantages because the economic pie grew larger. Government programs do little for the working poor, and usually harm them.

Labor shortages are best.

These citizens are best served by *economic growth* and *a low level of immigration*, because those are the conditions that create labor shortages and rising wages. Let's not kill the goose.

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"The current credit crisis will come to an end when the overhang of inventories of newly built homes is largely liquidated, and home price deflation comes to an end . . . . . Very large losses will, no doubt, be taken as a consequence of the crisis. But after a period of protracted adjustment, the U.S. economy, and the world economy more generally, will be able to get back to business."

-- Alan Greenspan, in the Wall Street Journal, December 12, 2007

Same article, full text, in plain English:

"There's going to be a recession, but it's not my fault. The housing bubble would have happened no matter what I did. But eventually the storm will pass, and we'll have smooth sailing."

And now a word from John Maynard Keynes:

"Economists set themselves too easy, too useless a task if in tempestuous seasons they can only tell us that when the storm is long past the ocean is flat again."

-- J. Maynard Keynes, A Tract on Monetary Reform, 1924

HOPE

Why do investors make bad decisions? Because they allow fear or greed—or need—to color their judgment. If you *need* to win at roulette (to cover medical bills or the mortgage, or to fund for retirement) you're much more likely to step up to the table and gamble recklessly.

The same is true for investing. The people who can least afford to swing for the fences often do, while those with adequate financial resources usually add to their wealth in a cautious and methodical manner.

Today millions of Baby Boomers feel that they need big investment returns to cover the shortfall in their savings. They know that they're taking big risks, so they like the security of traveling in a large herd of other gamblers who constantly reassure each other that they're doing the right thing. The result has been a series of bubbles in stocks, bonds, real estate, commodities, and currencies.

Today's herd mentality is the result of poor planning for retirement.

Emotion has no place in investing. The stock market's wild swings are often described in terms of greed and fear, but it's *hope* that causes the highest highs, and leads to the biggest crashes.

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"Be fearful when others are greedy, and be greedy when others are fearful."

-- Warren Buffett

QUADRUPLED !

Our benchmark account—a real account that one of our wonderful clients established in 1990—has continued to grow. The portfolio has always been invested just like our other "balanced" accounts, and our client has kept it segregated and untouched just so that we'd be able to track it. We don't show it any favoritism in trading, and it performs no better than its peers. It pays fees at a 1% rate, and it has always been invested in a conservative-yet-global mix of bonds, cash, and stocks. At year end the account stood at ***$461,826***, up from $100,000 in October of 1990—and up almost $10,000 from the end of August.

That excellent performance is matched by terrific service. Our full attention is directed to the needs of just 49 terrific clients who have given us the responsibility for managing more than $60 million. Further information regarding performance, fees, and our account minimum can be found at www.lumbard.com.

Most of the SEC's rules are very sensible, but we've always been puzzled by their requirement that we offer part II of our form ADV to clients and prospective clients each year. The form contains little information that anyone would find interesting, but the SEC requires that we offer it in writing—and that you respond in writing to request a copy.

We'll send you one even if you call on the telephone. Call us at (800) Lumbard, which works out to (800) 586-2273. That's Lumbard, not Lombard. (800) 586-2273.

Drew D. Kellner

During the last few months we've had the opportunity to speak with a number of our clients and prospective clients about financial planning. We discovered several issues that needed to be addressed. Some were missing opportunities related to IRAs, Roth IRAs, or other retirement plans, and others were getting tripped up by short term capital gains. Most seemed to be missing opportunities related to estate planning, trusts, wills, and charitable donations, and a few were struggling with the vagaries of college financing. If you have any questions about financial planning, please give us a call. We might not know the answers, but we can certainly direct you to someone who does.

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"A gallon of gasoline costs 6.3 cents at the pump . . . . And Venezuela is now gorging on gas. Venezuela will add 450,000 new cars this year . . . . Six Hummer dealerships are set to open early next year."

-- The New York Times Magazine

SHOCKING

For many Americans it now makes sense (dollars and cents) to go back to the electric baseboard heat of the 1960s.

THE 12,000-YEAR RECORD

"The incidents at Chernobyl and Three Mile Island are the only major accidents in more than 12,000 reactor years of [nuclear power] operation in 32 countries."

-- Douglas G. Maurer, CFA, Value Line Research

HATE

Hatred is all the rage. There is a joyous, mindless glee in hating Bush or hating Hillary, and at times it seems that the entire nation—voters, pundits, and politicians alike—has lined up to throw sticks and stones and embrace the bloodlust of sectarian warfare. Bush and Clinton are polarizing figures, but voters and the media should be ashamed of themselves for constantly pumping up the volume with the repetition and electronic distribution—millions at a stroke**!!**—of lies disguised as humor and fellowship. Hitler's propaganda minister used to say that a lie repeated a hundred times becomes truth, and we've seen his theory in action, in both liberal and conservative circles, many times in the past year.

Hillary has neither horns nor hooves, and Obama is not a radical Islamist, running for President so that he can destroy us from within. The 110 Capitol Hill Democrats who voted in favor of war in 2003 might *hate* the fact that they're on the record in support of George Bush, but those votes can not be undone by calling for surrender to terrorists. Especially at a time when the war is clearly ending.

Technology has played a role. On the Internet you can read what you want to read, and prove what you want to prove. There is an appalling absence of independent thought in the land, and even the mainstream media have pandered to the stampeding herds, offering news that fits the preconceived notions of their readers and viewers.

This herd behavior is all too reminiscent of the stock-market bubble, the real estate bubble, and all the other manias that have caused havoc in recent years.

The great question before us is whether we will recognize the newfound need to move beyond sound bites to listen to both sides of a story, or continue to congregate in ever-tighter opposing herds, bonded by groupthink and blind acceptance. Can we pull together and do what is best for the nation as a whole?

John Lumbard, CFA

NATIONAL REFERENDUM

PLEASE CUT OUT AND SEND TO YOUR CONGRESSMAN.

I _*(state your full name)*_ am tired of removing my shoes in airports. Being of sound mind and body, I do hereby certify my willingness to accept the risk that my fellow airline passengers have stuffed their footwear with high explosives. You can go ahead and let them on the plane.

Sincerely, ____________________________

Performance Results:

The performance results presented below are for our "Benchmark Account", using January 1, 1998 as the date of inception. The performance results for the Benchmark Account are calculated by Lumbard & Kellner, LLC's current custodian, U.S. Bank (prior to 2004 State Street was the custodian). The account pays fees based on our firm's fee schedule from the 1990s (top rate of 1%), and the percentages shown are net of fees and expenses—that is, the returns shown would have been higher if fees had not been deducted. The performance results for the Benchmark Account include the reinvestment of dividends and other earnings, but there have not been any other additions or withdrawals since inception. The comparative indexes shown are the S&P 500 Composite Index, Dow Jones Industrial Average, NASDAQ Composite, Barclays U.S. Aggregate Bond Index, and the Citigroup 3 Mo T-Bill Index.

Actual returns for individual client portfolios managed by Lumbard & Kellner, LLC may vary and will not necessarily coincide exactly with the returns for the "Benchmark Account." Past performance of the "Benchmark Account" does not guarantee future results. No assurances or guarantees can be given or implied concerning future investment results for Lumbard & Kellner, LLC or any investment index. Future returns may differ significantly from the past due to materially different economic and market conditions and other factors. Investments within portfolios, and therefore, portfolios, involve risk and the possibility of loss, including a permanent loss of principal.

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