Pzena Investment Management
Third Quarter 2008 Commentary

Panic dominates, so the choices are set: run and hide, or seek to exploit the opportunity. Our DNA makes the decision clear, and history provides some long-term comfort.

From Wall Street to Main Street, from the City to the Bourse, investors are panicked. This crisis of confidence has claimed victims that one year ago would have seemed laughable. Bear Stearns, Lehman, Merrill Lynch, Fortis, Bradford & Bingley, AIG, Wachovia, Fannie Mae, Freddie Mac, just to name a few. Unfortunately, we have been caught with some of these positions in our portfolios as we sought to exploit the fears, rather than hide from them.

Our approach of exposing the portfolio to the cheapest stocks has often protected our investors from the downside risks to the market, although that has not been the case for much of this cycle. Nevertheless, some interesting changes to market leadership are afoot. The value/momentum cycle appears to have begun to turn. While the current volatile market has been driven by emotion, the turn may actually be justified by the fundamentals for the two sectors at the heart of the cycle – commodities and financials. Historically, these turns come before the data is completely clear or consistent. But once the data is available to the market, the investment opportunity will have passed.

Momentum/Value Cycle Has Shifted

Equity investment returns have historically been dominated either by momentum or by value. Both styles are supported by long-term academic research, and coincidentally both have generated similar levels of excess long-term returns over the broad market. Momentum flourished in the most recent cycle as investors fell in love with the "Chindia" story and the fantasy of decoupling. As inevitably happens as each momentum cycles ends, the "story" collapses – in this case the sharp fall in commodity prices signaled the shift. In fact, it may surprise many that the best performing sectors for the third quarter were Consumer Staples, Health Care, Financials, and Consumer Discretionary. An underweight in the cheapest stocks (Financials and Consumer Discretionary) would have been costly for the quarter, despite all of the failures within the financial services industry.

The market's results during the current cycle, while extreme in some ways, mirror past cycles: a momentum-driven market has historically preceded recessions (Figure 1). Once the recession has begun, the market regains its focus on valuation. It has happened in every one of the past five recessions going back 40 years.

Our performance for the quarter was in line with the value indices despite having owned some of the companies that were victims of fear, and was ahead of the broader markets as value finally started to outperform. If we were to make an admittedly self-serving measurement from the mid-July peak in the momentum/commodity market (and the trough in financials/consumer cyclicals), the rebound allowed most of our strategies to generate approximately 400 basis points of excess return through quarter-end.

While it is still too early to call this a turn, it does appear fairly clear that we have entered a recession, which as noted has historically been good for economically sensitive stocks and for value in general. Yet another round of bad news is quite likely as

Figure 1: Average Annualized Returns of Momentum and Value Strategies

Before the beginning of a recession, investors disregard valuation and momentum strategies excel					*After a recession is under way, investors price in the recovery, refocus on valuations, and value strategies excel*			
Begin	**End**	**Momentum Annualized Returns***	**Value Annualized Returns***	**Recession Start Date**	**Begin**	**End**	**Momentum Annualized Returns***	**Value Annualized Returns***
Feb-69	Dec-69	2.9	(19.7)	Dec-69	Jan-70	Jan-71	(7.3)	23.3
Feb-71	Dec-73	13.2	(2.6)	Nov-73	Jan-74	Mar-77	2.7	27.0
Jan-78	Nov-80	51.1	18.0	Jan - 80 & Jul-81	Dec-80	Feb-84	9.8	26.5
Oct-89	Oct-90	(17.0)	(32.3)	Jul-90	Nov-90	Feb-93	25.0	45.1
Mar-97	Feb-00	67.2	7.4	Mar-01	Mar-00	Nov-01	(35.2)	23.6
Jan-07	Jun-08	17.3	(17.6)	June/Sep-08	Jul-08	?	(27.3)**	(6.4)**

**Gross of fees. Excludes periods when neither momentum nor value was outperforming. For the purposes of this analysis, momentum is defined as the hightest quintile of 1,000 largest stocks measured by nine-month price momentum. Value is defined as the cheapest quintile of 1,000 largest stocks measured by price-to-book.*
***Returns are for the period July 1st through September 30th. These returns are not annualized.*

Source: Empirical Research, Pzena Analysis the recessionary impact on earnings flows through the reported data. But the data that drove the momentum stocks higher has clearly turned and perhaps there are some signs that fundamentals causing the financial turmoil have begun to stabilize. We examine both factors below. In the meantime, while the world has embraced the doomsday scenario, and assigned valuations accordingly, we believe the risk/reward profile for value investors is quite favorable.

Cycle of Rising Commodities Has Been Broken

We've written about commodities before, how they're particularly prone to the boom and bust cycle, and that every prior commodity cycle has ended with collapsing prices. Earlier this year, as an insatiable Asian subcontinent seemed to gobble up the world's resources, we continued to remind clients and friends that it was inevitable that commodity businesses would return to normal profitability, and that the laws of supply and demand remain immutable. No question, this was a lonely perspective at the time.

The world had accepted the rising demand thesis: buyers panicked, perceiving a never-ending state of scarcity, driving record price increases in most basic commodities. But any price spike is followed by an inevitable ramp-up in supply, there's a build-up of inventories, and a slackening of demand, until finally, a collapse in prices. By mid-September, the bloom was off the rose: S&P GSCI (the Goldman Sachs commodities index) three-month returns were off 20%, driven by drops in energy, oil, and metals across the board. In August, investment funds flowed into commodities at their slowest rate in more than two years, according to Barclays Capital. The market had begun to catch up to our thesis.

Beginning in 2004, crude oil prices began a precipitous climb into unprecedented territory, hitting a peak of $146 on July 14th of this year. Was that driven by demand? In fact, as you can see in Figure 2, the growth in oil demand has been falling since the 2004 peak to an anemic rate approaching zero. While the forecast had been for demand to grow around 1.5% per year for the next four years, that is in doubt now as oil prices are higher and economic activity is weaker. The result is that OPEC's spare capacity should continue to increase. So the price momentum was driven not by demand but by perception. When perception changes, prices follow.

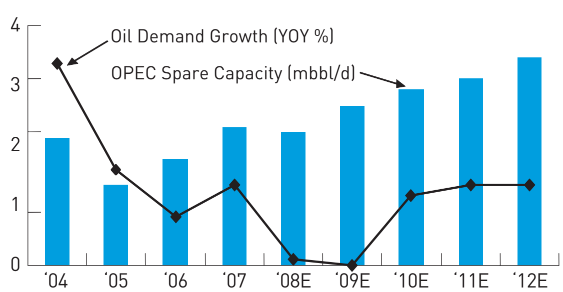
Financial Crisis More About Liquidity than Capital

The mark-to-market mentality of the investment community continues to pervade its thought process. The insistence that assets are ultimately worth only their going price (in contrast to accounting rules, which don't require such treatment) has exacerbated the panic in the financial sector and led to the demise of once-solid franchises. To make matters worse, the fear created by having to liquidate a portfolio of problem loans at today's distressed prices has caused depositors, funders, and creditors alike to be wary of lending to banks. Is the fear justified?

While it's true we have not yet entered the worst of the economic cycle, in fact the actual problem loans on bank balance sheets continues to be modest. As shown in Figure 3, non-current loans at commercial banks were still below 2% of total loans at the end of the second quarter, compared with nearly 4% during the 1990 credit crisis. Preliminary third-quarter data indicates it hasn't increased much beyond that.

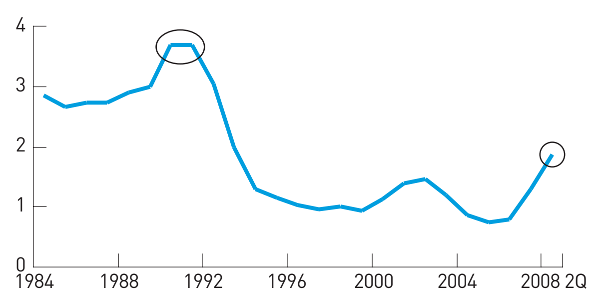
And banks still have a relatively large cushion against credit losses, nearly $9 of reserves and capital against credit losses,

Figure 2: Oil Supply and Demand



Source: Sanford C. Bernstein & Co., Pzena Analysis

Figure 3: Commercial Banks: Noncurrent Loans & Leases
As % of Gross Total

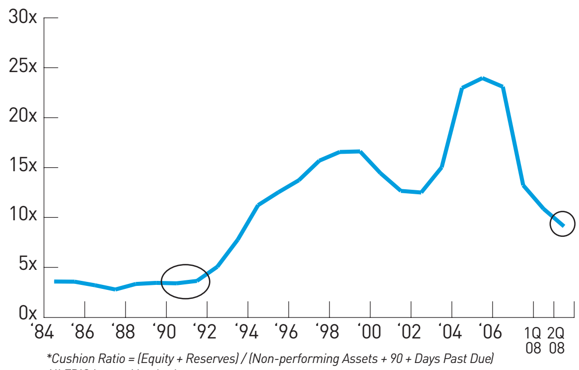


Source: FDIC, Pzena Analysis

nearly $9 of reserves and capital against every $1 of non-current loans, at the end of the second quarter, more than double the 4:1 ratio during the last cycle in the early 1990s (Figure 4). Again, our analysis indicates it won't fall much in the third quarter.

But in a panicked market, reassurances of stability are often no help. Once fears subside and lending resumes, the crisis in

Figure 4: Bank Cushion Ratio*



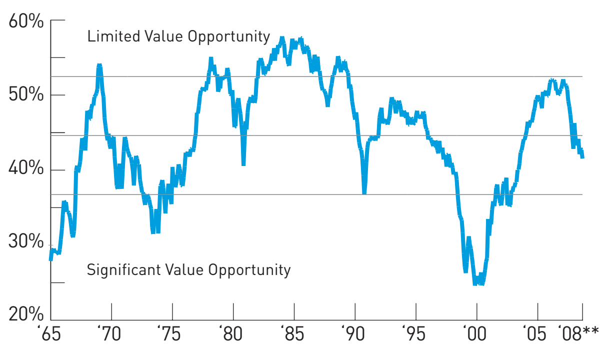
*Cushion Ratio = (Equity + Reserves) / (Non-performing Assets + 90 + Days Past Due)
All FDIC Insured Institutions
Source: FDIC, Pzena analysis

the financial system should abate. Most important to investors should be the valuation opportunity the crisis has created.

The Opportunity Now

Given the shifting fortunes of commodities and financials since mid-July, it's no surprise that the spread in price-to-book ratios for the two sectors has come off historic highs. Yet the value opportunity has actually increased. The cheapest quintile of the 1,000 largest U.S. stocks trades at a greater discount to the S&P 500 than it has in three years (Figure 5).

Figure 5: Cheapest Quintile of 1000-Stock Universe to S&P 500*



*Price-to-book ratios of 1,000 largest U.S. stocks; equally-weighted data
**Data through September 2008
Source: Empirical Research, Pzena Analysis

The market is beginning to sort out the winners and losers in the financial sector. Our portfolios are now stocked with financial names with strong franchises and adequate capital, such as banks with deposit bases that provide the resoures to take advantage of the liquidity crisis by buying high-quality assets on the cheap. We believe that the long-term earnings of many of these companies will ultimately capture more of the industry's robust cash flow once the recovery comes. Of course, the game-changing entrance of the government into the private sector, the end of independent banks as we know them, and unknown other changes to come will require us to continue to research each company. But it is when the market is under the greatest stress that a careful investor can find the greatest opportunity.

Conclusion

Armed with the facts above and our experiences in this crisis, we offer several observations:

1. ***The value/momentum cycle appears to have begun to turn.***
2. ***The data indicating such a turn is not yet well-established*** – but it never is until the turn has come and the investment opportunity has passed.
3. ***We are in the business of taking risks*** – tempered by our strict adherence to our investment discipline and our research process, of course, but required by that same discipline to expose ourselves to the stocks under the greatest pressure. Would it have been better in retrospect not to have owned companies that failed or were taken over? Of course. But would it have been better not to own any financials at all? We believe the answer to that will turn out to be a resounding no.

Ben Graham once said that the stock investor is neither right nor wrong because others agreed or disagreed with him; he is right because his facts and analysis are right. We look forward to the end of the current crisis and relying on the long-term results of our research. ■

DISCLOSURES

Past performance is no guarantee of future results. The historical returns of the specific portfolio securities mentioned in this commentary are not necessarily indicative of their future performance or the performance of any of our current or future investment strategies. The investment return and principal value of an investment will fluctuate over time.

The specific portfolio securities discussed in this commentary were selected for inclusion based on their ability to help you understand our investment process. They do not represent all of the securities purchased, sold or recommended for our client accounts during any particular period, and it should not be assumed that investments in such securities were, or will be, profitable.