

W. P. STEWART

& Co., Ltd.

W.P. Stewart 2008 Year-end Review

Issue 7
5 January 2009

Dear Clients and Friends of the Firm,

2008 is not a year any of us wants to relive. Two recent quotes from the New York Times sum it up: *“The worst year in 70 years”* and *“This is the year the financial system stopped working”*.

Most of us suffered very serious losses in 2008 and the S&P 500 Index ended the year down 37%. Even worse, that is nearly 30% lower than at the start of the century, nine years ago.

While our typical client* lost less than most, about 29%, pre-fee, in the past year, and about half of what was lost in the S&P 500 since year-end 1999, it is still the greatest loss they or we have had to endure. I wish we had foreseen the global financial meltdown. But we didn't. And I know that losing less than most others doesn't provide great solace.

In fact, after losing money in the stock market for most of a decade it is fair to question continuing to risk whatever capital one has left. As I pointed out in a letter some months ago, a reversion to the long-term historical mean – about 9% annual return in shares – would yield returns close to 20% a year over the next five years. But is that really a rational prospect? The odds look remarkably favorable to me right now. But timing will always be a challenge.

In this year-end report I will try to cover three areas: what we did right and wrong in the past year, how I see your portfolio's future prospects and bring you up-to-date on how we are continuing to strengthen our firm.

In Retrospect

We are all about buying a steadily growing stream of earning power behind your portfolio. We try to invest our clients' capital in solid, high quality businesses with sustainable growth prospects, and then watch them like a hawk. As a group, these investments have grown earning power by nearly 15% a year for decades and have only seen that profit grow by less than 10% once, in 2000.

Earning power behind our clients' portfolios expanded by about 10% in 2008, which was a few percent less than what we expected when we started the year. By contrast, earning power behind the S&P 500 average is expected to be down more than 10% in 2008. We expect the businesses you own to further improve profits in 2009, albeit modestly, despite a very poor economy, while S&P 500 earnings may very well fall another 10 – 20%.

* Excluding our leveraged fund, W.P. Stewart Holdings.

The dollar regained much of what it had lost against the Euro and the Pound earlier in the year, as we suggested last March in our article citing “the world’s largest short position”. Fortunately, the dollar remains cheap enough to sustain a positive export trend which can be very helpful to the American economy.

The boom in alternative and aggressive hedge fund investing faded significantly, as we projected in the same report.

We avoided energy and materials shares, having noted several times that commodity prices virtually always return to their marginal cost of production. Though at today’s depressed prices that argument is no longer valid for most commodities.

In contrast, we are seeing a nascent movement toward traditional investment disciplines. In particular, investors seem to be focusing on investments and investors that offer transparency, liquidity, safety and security. In time, that should provide support for the kind of investing to which we’re committed.

Your portfolio’s price/earnings ratio was at a historically low level at the start of 2008. It was a little more than 17 times forward 12 months estimated earnings per share, near the very bottom of a range of between 30 and 17 for most of the past few decades. In my letters to you earlier last year I imagined at least some improvement from that low. So far, that clearly hasn’t happened. Continued selling pressure drove our clients’ portfolio P/E ratio down to a low of 12 several weeks ago and it is still below 14. Based on more than 50 years experience, that’s a level I thought very unlikely, particularly considering the high quality of these earnings.

Deleveraging a financial system that turned out to be far more extended than most of us realized created extraordinary liquidation of all kinds of marketable assets; from homes to shares, many commodities and corporate and municipal bonds. Declining prices engendered further selling as fiduciaries rushed to “protect” assets from further declines – the classic negative feed back loop.

This forced selling has driven normally “safe” holdings to exceptionally cheap levels while simultaneously building up huge cash reserves. ISI, Wall Street’s leading economic research firm, has recorded the largest cash hoard since they began monitoring that metric more than two decades ago – more than \$11 trillion in cash and Treasuries. That is \$3 trillion greater than the combined market value of all the companies in the S&P 500 Index.

Prospects

If the world economy gets back on an even keel, the eventual rebound from currently depressed share prices is likely to generate enormous gains over the next several years. So it is imperative that we focus on that prospect.

As the real money in our trade is always made by investors looking forward with a certain amount of acumen, rather than backward at what worked most recently, we must try to independently discern how the economy is going to develop rather than simply accepting the consensus – which, as we’ve seen, is as likely to be wrong as right.

Forecasts for America's consumer driven economy are as uniformly bleak today as they were positive on technology ten years ago and on energy in 2007 and early 2008. Six months ago investors were caught up with forecasts of \$200 per barrel oil and the prospect of run away inflation. Now oil is around \$40 and we hear a lot about a re-run of the great depression and deflation.

Last October, ISI listed six things they thought had to fall in place to get the market turned around:

- Oil prices down
- Inflation down
- Interest rates down
- Policy responses to the problems
- Mortgage rates down to 4.8%
- Credit market improves

Here is where we seem to be now:

- Oil is down 50% since October and 70% from its earlier high - equivalent to a \$2 trillion tax cut for American consumers.
- Inflation is approaching zero.
- Government bond and notes are yielding zero to three percent – near record lows. Consumer rates are still fairly high, though mortgages are becoming much more attractive. Also, lower rates mean higher asset values in the long run – a very important part of the recovery process.
- We expect an enormous stimulus package to go through Congress shortly after Mr. Obama takes office in about three weeks.
- Mortgage rates are now closing in on 5% and banks are seeing a three year high in new mortgage applications. Housing affordability is approaching an all time high too. It looks like a great time to buy a house, if you have a job.
- Credit markets are still suffering but there are numerous signs that things are improving. Aggressive buying of mortgages by Fannie Mae and Freddie Mac, now government controlled, is a great start. The Fed has also jumped in with both feet. While banks are still hesitant about lending, let's hope that they'll feel a little better as the year progresses. Many banks are still well capitalized and I'm sure their competitive juices will start driving the process as soon as they see a little momentum develop.

On balance, it seems to me that we are making real progress amidst this "fog of war". Though changing the direction of the world's economy can certainly take another year or two, markets always look ahead. If significant economic improvement is likely later in 2009 the market should start moving ahead soon. If it is going to take two more years to turn the economy around we are probably in for some more grief. But with things falling in line as they are, increasing money supply, light inventories, lots of cash on the sidelines and all of the stimulus that is likely to be applied here as well as around the world, I'm guessing improvement will be sooner rather than later.

As a group, the businesses we've invested your money in are relatively non cyclical, and profits behind your portfolio should be able to double in the next five to six years. If over that period P/E ratios even regain the bottom of the 17 -30 range of the decades before 2008, your portfolio could double or triple in value.

The Stock Market Effect

One reason for my guarded optimism is that the stock market itself can be an important factor in turning the economy around. When the Fed pumps cash into the system, as they are doing now, much of it ultimately ends up in additional liquidity on bank balance sheets. This facilitates capital expansion for business and consumer spending or it shows up in the financial markets. The banks have indeed been bulking up cash on their balance sheets but they are under great pressure from the government, which is often a new large shareholder now, to move that cash into loans – so they may not be able to go much further in that direction. With business already operating well below capacity there is little likelihood that the Fed's cash will end up in capital goods right away. With a high unemployment rate, consumers are also likely to remain cautious for some time to come, so I don't see the increasing money supply going there either. It seems to me that by process of elimination the financial markets could be a primary beneficiary. A rising stock market is just the ticket for improving confidence and getting the economy rolling again. This concept is not lost on Mr. Bernanke.

A Reversion to the Mean

George Soros coined the word “reflexivity”; simply put, what everyone is presently thinking and talking about is reflected in current prices. That consensus is not always wrong. But it *is* always wrong at major turning points. We only have to watch CNBC for a few days to comprehend the level of today's pessimism. Of course, that shows up in record low valuations for lots of things today – and in particular for shares in the high quality businesses in which we focus your investments.

If the economic outlook gets even a little better than it currently appears we should rationally expect a traditional reversion to the mean, something a little more “normal”.

Of course, timing is difficult. Warren Buffet has always recommended “pricing” rather than “timing”, as the former, while still subjective, is not nearly as dependant on luck. But the magnitude of the eventual advance is likely to be commensurate with the depth and angst of the preceding decline. That is one good reason for hanging on – or adding to the portfolio now.

The last time we endured a market decline of the magnitude we've just experienced was 1973-74. In October of '74 I suggested to my partners that we were likely to see at least ten great years ahead while depressed investors gradually regained confidence in long-term investing. In fact, give or take a few rumbles along the way, we ended up with closer to three decades of good markets.

Stocks and corporate bonds are cheap today. Quality and interest rates considered, they are even cheaper than they were in 1974. There is a lot of cash on the sidelines. If the

government succeeds in breaking the present downward spiral, the seeds are planted for a major advance over many years.

Don't Fight the Fed

The Federal Reserve has intervened in the American economy many times over the years and it has a perfect record of winning every time. This time the Fed, most of the rest of the world's central banks and Congress are determined to put the train back on the tracks. No doubt it is a bigger job this time around than in most of the past several decades but history shows that there is a good chance that the old adage not to fight the Fed is probably still valid.

An analysis of government moves and probable outcomes will be the subject of another memo.

Strategy

While a return to the mean is almost certain in time and we can model conditions indicating that economic conditions will turn for the better within a year or so, with the stock market moving up sooner, we can never be certain. Appropriate investment strategy still entails holding significant "sleep at night reserves" as I suggested in my letter to you last September, "An Action Plan".

Importantly, one doesn't simply decide to be "in the market" or "out of the market". We allocate resources after trying our best to weigh risk and reward. Each of us has our own "sleeping point". If I were 40 years old I might be happy enough with 10% in cash or very high grade bond reserves. In my 70s, 30-40% feels more appropriate. But once having decided how much to put aside, I am a strong believer in investing the rest to make real money because you have to be in before the rise starts or you'll miss a lot of it.

Popular Delusions

The investment of choice in one market cycle often seems to become the most derided holding in the following cycle – witness tech and "dot coms" several years ago and leveraged hedge funds and energy and materials shares more recently. Clearly, the most popular investment today is cash, for which one is currently paid hardly any return at all.

There is little question that global overcapacity and capital destruction have become a significant deflationary force and cash or its near equivalent, Treasury bills, could provide a modest real return in deflationary times. But if the developing world-wide effort to stimulate business and consumption succeeds, as I hope it will, Central Banks will be hard put to pull back money supply growth and government spending quickly enough to avoid reflating in a few years. That in turn would reduce the value of cash while increasing the prospective value of productive assets.

In that scenario cash holdings become a wasting asset and currently depressed shares and corporate bonds are likely to regain center stage. Today's investment of choice could become tomorrow's disappointment and vice versa.

W. P. Stewart & Co.

No one is more aware than I am that clients and employees prefer successful firms of high integrity. Our firm went through a serious internal challenge in recent years. We had to refocus on our core mission, change management, streamline costs and improve many aspects of how we develop and deliver consistently better than average investment returns with below average risk. This should always be a work in progress, and we continue to make good headway.

Our long-term investment record remains among the best in our industry, as is performance over the past 18 months or so. The investment team remains as committed and hard working as ever. It is clearly focused on what we have always done - investing your money in the highest quality, steadily growing businesses we can find. Our tremendously experienced client service people are a delight to work with. Our operations people, many of whom have been with the firm for decades, are truly outstanding. While all of us are as concerned as you are about the financial world we are coping with, I must say that this team is as professional a group as it has ever been my pleasure to work with. Importantly, they care.

When I came back to the firm full time almost two years ago I had four very specific goals:

- Improve investment performance
- Upgrade client service
- Develop new leadership in management
- Bring in a financial partner

Here is where we stand today:

Our investment performance over the past two years is significantly better than most, though, as I said at the start of this letter, I know that losing less than others doesn't provide great solace.

Our tight knit, highly experienced client service team is motivated, dedicated and committed.

I hope you share my confidence in Mark Phelps who took over as CEO several months ago. He is organized, focused and energetic. He also knows our profession. Mark is 49 years old with more than 25 years in the investment business. He has been with our firm for nearly five years and is widely respected by our clients and employees.

Several months ago, Arrow Capital Management, run by Alex von Furstenberg and Mal Serure, made a substantial investment in the firm. As a result, we go into 2009 with \$41 million of cash and marketable securities, no debt, much reduced operating overhead and a real partnership with Arrow.

Making these changes as a public company in a terrible market has been a challenge. One of our directors likened it to fixing a broken airplane wing while in flight. But my initial goals have been accomplished and we are ready to move ahead. As we now have far fewer shareholders, it no longer makes sense to deal with the exceptional effort and expense of

retaining a full scale registration with the SEC, and we are pulling back our share registration and will be listed OTC and on the Bermuda Stock Exchange for the foreseeable future.

We are determined to be the successful firm we all want to be part of. We have always stressed integrity and putting the client first. We have a long record of accomplishing our investment goals and we have a shared commitment to work even harder to put the firm back on top.

Starting from presently depressed markets, I think the opportunities to distinguish our firm, our associates and our clients are as exciting as they were 34 years ago when we started W. P. Stewart and Co. You and I have a fine, dedicated team working for us. With a little luck we will all reap the benefits in the years ahead.

As always, please call or email me with any questions or suggestions.

Happy New Year

William P. Stewart

W.P. Stewart Representative Offices

Please contact one of our offices if you would like to discuss our investment opportunities or to receive more detailed information.

Headquarters	North America	Europe	Asia
W.P. Stewart & Co., Ltd. Trinity Hall, 43 Cedar Avenue Hamilton HM LX Bermuda	W.P. Stewart & Co., Inc. 527 Madison Avenue New York, NY 10022 United States of America	W.P. Stewart Asset Management (Europe) N.V. WTC Amsterdam Airport Schipholboulevard 127 1118 BG Luchthaven Schiphol The Netherlands	Bowen Asia 1008 Shui On Centre 6-8 Harbour Road Hong Kong
T + 1-441-295-8585	T : + 1-212-750-8585	T : + 31-(0)20-201-4985	T : + 852-2845-0956
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