Boulegeris Investments, Inc.

Azimuth North

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In 2008, heightening systemic market risk, triggered by the bankruptcy of Lehman Brothers, led our firm toward three key actions to preserve capital:

- Aggressive selling of covered calls as a hedging strategy
- Realizing gains in energy and commodity holdings (our forecast of a 25% correction in oil prices proved accurate in the face of $150-$250 price targets offered by venerable Wall Street Firms and industry leaders)
- Raising cash levels by an additional 15% in late September.

These collective judgments are representative of a defensive strategy that helped the firm outperform the benchmark S&P 500 index for the ninth consecutive year. While past performance is no guarantee of future results, with the S&P Index currently at 768, we now go on record that the US equity markets are poised to advance in the 2009-2010 period. As our clients who have engaged in their annual portfolio reviews have heard, our analysis suggests a modest single digit gain in 2009 and an upper single digit gain in 2010.

Reflecting on a very difficult year, investors experienced a virtual implosion of global equity markets. The worldwide dissemination of structured investments that transformed into “toxic” assets was enabled by Financial Accounting Standards Board Rule 157 (FASB 157). FASB 157 placed downward pressure on financial institutions to “mark to market” complex securities for which a viable market no longer exists.

The effect of a lethal combination of financial engineering in the credit default swap (CDS) market, the FASB 157- induced destruction of approximately $8 trillion of lending capacity and the damage done to regional banks which were required to own preferred shares of Fannie Mae and Freddie Mac coalesced into a credit paralysis. The seizure of the credit markets, not seen since the Panic of 1907, was further magnified by the lax regulatory environment that was supportive of hedge funds at the expense of the individual investor. The ensuing deleveraging in the current recession is manifest in plummeting prices of residential housing, the collapse of energy and commodity prices, downsizing of the balance sheets of the banking industry and severe stress on personal balance sheets.

There are early signs that the US equity markets will bottom in the first half of 2009 as the preconditions are emerging. The following critical elements will contribute to the stabilization of the US financial infrastructure, bringing equilibrium to the residential housing sector and improvement in employment conditions:

- The US Treasury's $1 trillion program of purchasing toxic assets and partnering with private equity to rehabilitate them (the "Dutch Plan"), is moving forward. This Treasury program will provide relief to major US banks and enable the expansion of lending-an essential element to unlock the credit markets.

- The US Federal Reserve recently launched a $1 trillion program to purchase Treasury bonds and agency paper (Fannie and Freddie). Immediately, mortgage rates declined and are now approaching 4 ½%. This bodes well for refinancing in the housing sector and strengthening of the beleaguered US consumer.

- The Fed Funds rate has been lowered to virtually zero. Unprecedented liquidity will work its way into the system. With a lag time of six to nine months, this accommodative interest rate environment will begin to have a stimulative effect in the third quarter.

- Adopting the lessons learned from the FDIC's successful modification of mortgages at California-based Indy Mac, the Housing Recovery Act should result in slowing the rate of foreclosures, a prerequisite for stabilizing residential housing.

- A $787 billion fiscal stimulus will result in job creation and preservation. Other fiscal packages have been initiated worldwide- most notably in China which enacted a four trillion Yuan ($585 billion) program earlier this year. There are expectations that a coordinated global fiscal stimulus package will emerge at the G20 meeting next month.

- Moderating energy prices translate into a $1 trillion aggregate savings for the US consumer. While a weaker USD may result in upward pressure to oil prices, demand destruction and a more vigilant CFTC should impede runaway increases.

The above summary of tangible market catalysts is not all-inclusive. Other programs such as FDIC guarantees to protect money market funds and innovative approaches to enable corporate financings in the fixed income markets are also noteworthy. All of these actions may not have immediate effects. For example, employment losses in June may trend into the 450,000 range, which is no cause for celebration; however, that monthly loss would compare favorably with the 598,000 jobs lost in February. In other words, upcoming reports may be "less bad" than previous ones, which would be positively received by financial markets that always look ahead.

We caution much work remains. In his testimony before Congress, Mr. Edward Liddy, the new CEO of AIG, described in stark terms how an internal leveraged hedge fund dealing in credit default swaps has nearly brought down the company and imperiled the entire global financial system. AIG continues to reduce its derivative book. There remains embedded systemic risk in the existing CDS market that should be quickly reined in by regulators to avoid any more AIG-like meltdowns.

Historic and unprecedented fiscal and monetary stimulus programs support the preconditions necessary to stabilize the US economy and financial markets. Improvement of the financial condition of the US banking industry coupled with the unwinding of leverage is a harbinger of more favorable equity markets.

We are further encouraged that there is growing public demand for much needed regulatory oversight and continues to advocate for the following:

- Reinstatement of the Uptick Rule of 1938
- Enforcement of the prohibition against naked short selling
- Tightening the SHO rule that facilitates naked short selling
- Enforcement of the Failure to Deliver rule, which has enabled short sellers and hedge funds to destabilize prices. The SEC Inspector General recently reported over 5,000 complaints of naked short selling that were submitted to the SEC without one enforcement action.
- Modification of FASB 157 by suspending fair value accounting rules as they apply to Tier II and Tier III capital
- Mandatory registration of hedge funds with requirements that would limit leveraging and provide transparency as to their daily transactions and positions
- Reigning in the CDS market with regulatory oversight, collateral requirements and transparency of settlements. The objective should be to close this casino-like opaque market within 12-15 months
- Renewed enforcement to quell malicious rumors distributed by market participants and business media.

Enactment of this regulatory agenda reinforces key government programs, dampens market volatility, and potentially acts as an accelerant. Indeed, adoption of these regulatory imperatives would cause us to re-evaluate our upside targets and would likely result in a more aggressive equity allocation model for our discretionary accounts. By protecting the public good, this agenda would help restore trust and confidence and sustain a market recovery.

In the current climate, that appears to be moving in the direction of the reforms we endorse, our investment strategy remains focused on proven companies with high quality earnings, solid dividends and fortress balance sheets that serve as an antidote to the riptide of deleveraging. Evidence points to a high probability of market recovery following a historic lost decade of equity investing. Often this recovery can occur when least expected and be violent to the upside. Foundational to our analysis is an underlying conviction that the best days for America lie ahead. US-based corporations, small business and entrepreneurs alike sustain an innovative spirit and a zest for solving pressing societal needs. We continue to have great faith in the resilience of our nation and its people. Quality securities are selling at discounted prices, with $4 trillion parked on the sidelines. Though the exact timeline for a market recovery is difficult to pinpoint, we believe that for patient investors with a 3-5 year horizon, generational opportunities abound.

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