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ECONOMIC & MARKET Update

BRIEF MARKET COMMENTS

OCTOBER 3, 2008

Since early September the financial markets have been rocked by a series of unprecedented developments, including the early September collapse of Fannie Mae and Freddie Mac, the subsequent bankruptcy of Lehman Brothers, the announced sale of Merrill Lynch to Bank of America, the bailout of AIG, and a potential massive federal bailout bill. These events have underscored the severity of the crisis, which now threatens the viability of the U.S. financial system and the U.S. economy.

Given the fluidity of the situation, it's premature to attempt to assess the longer-term implications of this crisis. In the meantime, we would, however, offer several observations:

1. For several years now our portfolios have had little direct exposure to lenders or investment banking firms. We entered 2008 with minimal exposure to lenders. Our portfolios have been buffeted by the recent economic events, but the markdown has been mild relative to previous bear markets and is unlikely to result in a permanent loss of capital.
2. The crisis is severe. The seeds of this crisis began in the mid 1990's, when the nation's economic policy was altered to increase the rate of home ownership above the natural rate. Two major Government-Sponsored-Enterprises (GSE's) Fannie Mae and Freddie Mac, used their implied backing of the federal government to imprudently leverage their balance sheets and extend mortgages to buyers that should have remained renters. Fannie Mae and Freddie Mac also lobbied Congress to forestall effective oversight of their operations. Financial "innovation" by Wall Street magnified the potential for systemic risk. Finally, the expectation of continually rising home prices became the dominant factor in underwriting discipline.
3. The collapse of Bear Stearns in March, and more recently the bankruptcy of Lehman Brothers and the government bailout of AIG exposed the extent of counterparty (receivables) risk.
4. The Treasury and the Fed have been trying to contain the damage through a variety of interventions. Thus far they have not succeeded in restoring confidence in the commercial paper markets (non-federal short-term credit markets). The granting of credit seems to have been sharply curtailed. There is a potential "run on the bank." Money market funds have sold for less than $1.00. The politicians in Washington are trying to put together a massive bailout package.
5. Interest rates remain low. Treasury Bills sold at a negative rate of interest briefly last month and closed one day at a yield of 3 basis points.
6. The price of oil and other commodities have fallen sharply. The dollar has been strengthening. The Federal Open Market Committee (FOMC) has more flexibility to ease if needed.

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7. It is likely the severe credit crunch will affect the real economy. Whether the economy suffers a major recession is not predictable at this point. Such events will depend on the appropriateness and effectiveness of recent and future policy responses by the Treasury and the Fed.

How has DGI been investing your money during this tumultuous period?

1. We believe we recognized early that this crisis would become severe. Thus far, we have not been remotely tempted to invest in lenders or investment banks. We have simply not been able to figure out what these companies are worth with a sufficient degree of accuracy to make an informed investment judgment.
2. We have maintained our maximum equity exposure because our work, which is based on reasonable forecasts, shows a very high expected return from our stocks. The future returns from money market instruments and bonds are simply not competitive with the returns available from stocks.
3. We have been selectively investing in companies that meet the following criteria: excellent, sustainable franchises benefiting from globalization and technological innovation where the company's stock price allows us to achieve our hurdle rate over the long term.
4. Until recently, it has been sufficient for us to simply avoid the financial lender's stocks. Now we are beginning to analyze the origins of this crisis. We believe a thorough understanding of the basis of this crisis will help us understand when progress is made and will help us find more winning stock ideas.

What should you as our customer do?

1. Review your tolerance for downside volatility. Only invest in stocks to the degree that you can handle a temporary markdown in your portfolio without panic. We are available to discuss your risk parameters at your convenience.
2. Read and digest the financial news headlines but do not let your investment decisions be influenced by the headlines. Remember, the news reporters are paid on viewership. If they were good investors, they would be in the money management business.
3. Continue to be patient.

Thank you for your support.

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