Horizon Asset Management
2nd Quarter, 2008
Manager's Commentary

The subject of focus for this quarter is the concept of "risk premium." Barron's defines "Risk Premium" as *in portfolio theory, the difference between risk-free return and total return from a risky investment. In the capital asset pricing model, the risk premium reflects market related risk as measured by Beta. Other models also reflect specific risk as measured by Alpha.* There is an entire industry built around the measurement, analysis and marketing of *Beta* and *Alpha.* It can become quite abstract. Horizon will define the "risk premium" as the discount reflected in share prices that can be attributed to pessimism. These definitions are important as context for performance analysis.

Measuring Pessimism, or *Why You Were Better off During the Great Depression*
Currently, the sentiment in the stock market is negative. In fact, for most of the current decade the sentiment in the stock market has been negative. It is very important to note the extent of the current pessimism and how it compares to other negative periods in the history of the stock market. For example, between January 1, 2000 and December 31, 2007, the following returns were observed (using the S&P 500 index):

Year	Return	Compounded
2000	-9.11%	-9.11%
2001	-11.80%	-19.84%
2002	-22.10%	-37.55%
2003	28.70%	-19.63%
2004	10.87%	-10.89%
2005	4.90%	-6.53%
2006	15.80%	8.24%
2007	5.49%	**14.19%**

(Source: Ibbotson 2008 Classic Yearbook, page 23)

More pertinent, while the stock market gained 14.19% in the first eight years of the decade, in real terms, the gains were negative as inflation rose at a faster rate:

Year	Inflation	Compounded
2000	3.4%	3.40%
2001	1.6%	5.05%
2002	2.4%	7.58%
2003	1.9%	9.62%
2004	3.3%	13.24%
2005	3.4%	17.09%
2006	2.5%	20.01%
2007	4.1%	**24.93%**

(Source: Ibbotson 2008 Classic Yearbook, page 335)

Consequently, in real terms, the stock market's return from January 1, 2000 to December 31, 2007 was a negative 9.23% (which corresponds to an annualized negative real return of 1.11%) as the table below outlines:

Year	Return	Inflation	Real Return	Compounded
2000	-9.11%	3.4%	-12.20%	-12.20%
2001	-11.80%	1.6%	-13.21%	-23.80%
2002	-22.10%	2.4%	-23.97%	-42.06%
2003	28.70%	1.9%	26.25%	-26.85%
2004	10.87%	3.3%	7.21%	-21.58%
2005	4.90%	3.4%	1.33%	-20.53%
2006	15.80%	2.5%	12.91%	-10.28%
2007	5.49%	4.1%	1.16%	**-9.23%**

While it is widely acknowledged that the stock market was in a bubble in the year 2000, these returns (or lack thereof) are still remarkable from an historical perspective – they contain critical information content for investors today. One would do well to compare these 8-year results to the returns generated in the most extreme 8-year time period in history: The Great Depression. The following tables use the period January 1, 1929 to December 31, 1936, which also began at the close of a bubble. It is noteworthy that in the three years leading up to 1929, the stock market gained over 120%, most similar to the 108% gain recorded in the three years leading up to the year 2000:

Year	Return	Compounded
1929	-8.40%	-8.40%
1930	-24.90%	-31.21%
1931	-43.30%	-61.00%
1932	-8.20%	-64.19%
1933	54.00%	-44.86%
1934	1.40%	-44.09%
1935	47.70%	-17.42%
1936	33.90%	**10.58%**

(Source: Ibbotson 2008 Classic Yearbook, page 294)

So, while the Depression was clearly grim as the economy contracted, it will doubtlessly surprise some to learn that this period actually provided a double-digit cumulative return (at least for those who had the presence of mind and fiscal wherewithal to remain invested; this phenomenon will be the topic of future commentary). The stated nominal return, at 10.6%, was somewhat lower than the 14.2% return from 1999 to 2007.

However, the nominal return is not the real return. The term "real" has a double meaning, although much related, in common usage and economics. In economics, the real return reflects the impact of inflation, since a 10% stated return might or might not purchase the same quantity of goods and services in different periods. During the Great Depression, there was not much inflation. In fact, there was deflation, as the table below indicates. There were actually years when the interest rates on U.S. Government Treasury Bills were zero and even negative. As odd as it might seem to someone whose sole experience is in an inflationary environment, a holder of those Treasury Bills would have been quite satisfied with a near-zero, zero or even negative return, and not because it was merely a safe haven. It is because with every passing week, as prices declined, the same

nominal dollar amount of savings could purchase yet more goods and services; in real terms, the zero-percent Treasury Bill represented a positive return.

Year	Inflation	Compounded
1929	0.2%	0.20%
1930	-6.0%	-5.81%
1931	-9.5%	-14.76%
1932	-10.3%	-23.54%
1933	0.5%	-23.16%
1934	2.0%	-21.62%
1935	3.0%	-19.27%
1936	1.2%	**-18.30%**

(Source: Ibbotson 2008 Classic Yearbook, page 330)

Therefore, on a real basis, the return during the 1929-1936 period was noticeably superior to that of the most recent 8-year period:

Year	Return	Inflation	Real Return	Compounded
1929	-8.40%	0.2%	-8.58%	-8.58%
1930	-24.90%	-6.0%	-20.39%	-27.23%
1931	-43.30%	-9.5%	-37.91%	-54.82%
1932	-8.20%	-10.3%	1.26%	-54.25%
1933	54.00%	0.5%	53.23%	-29.90%
1934	1.40%	2.0%	-0.63%	-30.34%
1935	47.70%	3.0%	43.27%	-0.20%
1936	33.90%	1.2%	32.29%	**32.03%**

During the 8 years from January 1, 1929 to December 31, 1936, the real return was a *positive* 32.03%, whereas in the first eight years of the current decade, the real return has been a *negative* 9.23%. In addition, the stock market is currently down another 14% year-to-date, and inflation (as measured by the CPI) is currently up almost 4% compared to 12 months ago. We are clearly seeing a continuation of purchasing power erosion.

The value of this exercise is the evidence it provides of the extent to which investors anticipate, as manifested in share prices, the most grievous economic decline -- far worse than the Great Depression. This, too, might sound odd. Presumably we know that basic economic conditions today are nothing like those in the Great Depression, nor could they be. The money supply was shrinking during that period, it has been expanding during this period. International trade, such as it was, was being dramatically curtailed by protective tariffs; the largest U.S. companies today are not only characterized as multi-national rather than domestic, they derive the greater part of their growth from the rest of the world. This applies as well to Coca-Cola as to NYSE Euronext. The spending capabilities of consumers today are buffered by forms of transfer payments such as social security and pension, and the capacity to borrow and methods of borrowing that simply did not exist then. The tables below, via merely two basic measures, illustrate the vast differences between that period and this:

Annual Change in GDP[1]			
1930	(8.9%)	2000	3.7%

Unemployment Rate[2]			
1929	3.3%	1999	4.0%

1931	(6.4%)	2001	0.8%	1930	8.9%	2000	3.9%
1932	(13.0%)	2002	1.6%	1931	15.9%	2001	5.7%
1933	(1.3)%	2003	2.5%	1932	23.6%	2002	6.0%
1934	10.1%	2004	3.6%	1933	24.9%	2003	5.7%
1935	8.9%	2005	3.1%	1934	21.7%	2004	5.4%
1936	13.0%	2006	2.9%	1935	20.1%	2005	4.8%
1937	5.1%	2007	2.2%	1936	17.0%	2006	4.4%
1938	(3.4%)	2008	3.7% (Q1)	1937	14.3%	2007	5.0%
				1938	19.0%	2008	5.5% (May 08)

(1) Source: US Dept. Commerce, Bureau of Economic Analysis
(2) Source: US Dept. Labor, Bureau of Labor Statistics

With a world view this dire, one might well imagine how dramatically the stock market can rise over the next few years (or months) if any but the direst economic scenario unfolds.

The Impossibility of the Market Forecast(s)

Now, back to the concept of risk premium. Astonishingly, as evidenced above, in one sense the risk premium has expanded more since the 2000 bubble peak than during the Great Depression. This pessimism has become so embedded that it is applied to the pricing of securities irrespective of logic: today one can readily observe mutually exclusive negative outcomes forecasted in the market simultaneously.

For instance, a major argument in favor of a potentially serious global recession is the rising price of crude oil. It is widely reasoned that this will not only exert great inflationary pressure upon the economies of oil-consuming nations, but will also diminish consumer spending. The clearing price of virtually every commodity has risen steadily over the past few years, which many well informed individuals believe is a sustainable trend. Coupled with the absence of borrowing power against one's home due to the housing recession, many astute investors have dramatically shifted their bias against equities. Yet, other very astute investors believe the current level of commodity prices is unsustainable and that the entire commodities market is representative of a bubble, virtually certain to collapse.

Obviously, both forecasts cannot be true. What is fascinating is that companies on both sides of the argument are priced for the *negative* earnings scenario. These range from auto manufacturers (Toyota trades at 11.2x 2009 estimated earnings, the auto dealership AutoNation at 7.5x) to consumer products companies (Energizer Holdings at 10.8x 2009 estimated earnings), which are believed to be in a perilous position due to a potential decline in consumer spending as well as exposure to higher raw material and manufacturing costs.

However, these discounted multiples should be compared with the valuation experience of oil and commodity production companies. The following P/E ratios are based on 2009 consensus estimated earnings: ExxonMobil, 9.0x; Total 8.7x; Rio-Tinto, 12.4x; Freeport-McMoRan Copper & Gold, 9.3x.

Clearly, the only scenario reflected in the valuations of these consumer retail and commodity production companies is a bearish one. Yet, the viewpoints that support these valuations are diametrically opposed. Ergo, some of these companies will experience success and some will experience earnings failure, but both are not likely to experience failure, although this is predicted by their valuations. It is our belief that this mindset (other examples of which could be cited as well) represents a mirror image of the positive mania experienced during the Technology bubble, when stock prices were not reflecting *unimaginable* future success, but *impossible* future success. It appears that valuations at this juncture in time reflect impossibly grim results.

A Word About the Portfolio

As an example, let us discuss a dominant theme in Horizon portfolios that has been deeply affected by this risk premium phenomenon: the securities exchanges. This sector has experienced significant increases in risk premium (a cordial way to say that stock prices are down). When one looks at the businesses of exchanges, one observes a bounty of robust operating statistics: significantly increasing volumes, increases in year-over-year revenues, expanding margins, and continuous expansion into new markets. Related, quite recent facts not to be ignored:

- NYSE Euronext (New York Stock Exchange) has a planned $1 Billion stock buyback, to occur when its purchase of the AMEX is complete.
- CME Group (Chicago Mercantile Exchange) has announced a $1.1 Billion stock buyback and a cash payment of $5 per share, to occur when its deal to purchase the NYMEX closes.
- London Stock Exchange is engaged in a $1 Billion share repurchase program. As of May 21st, they have spent approximately $115 Million buying back shares.

One of the reasons for the simply munificent earnings environment for the exchanges is the uncertainty about and divergent expectations for commodity prices and the very credit, exchange and energy price volatility that has caused such alarm and damage elsewhere. These are challenges and risks that must be addressed by millions of businesses and investors, and it is via financial instruments, traded on exchanges, that much of this is accomplished.

Lest one conclude that only Horizon believes that earnings are robust at exchanges, one may readily view the consensus earnings estimates for these companies by Wall Street research firms. They are among the most robust earnings expectations one can find. Yet, the shares have declined most sharply. The intersection of rapidly expanding earnings and declining share prices has quickly produced the phenomenon that these possibly most profitable companies in the world are also trading at merely 12x next year's earnings. There is a world of difference between a P/E multiple of 12x for a securities exchange with a 40% net after-tax profit margin and 12x for an automobile or battery manufacturer or mining company. For those who wax wistful over their missed opportunity to purchase blue chip stocks like Merck in 1982, when it traded at a single-digit P/E ratio and a 7 ½% dividend yield, they should consider carefully what lays before them today.

	Consensus Est. of '08 vs. '07 Earnings Change	Consensus Est. of '09 vs. '08 Earnings Change	P/E Ratio Based on '09 Estimates	Year-to-Date Price Change
Chicago Mercantile Exchange	20.4%	23.4%	19.4x	(36)%
NYSE Euronext	26.7%	24.7%	13.5x	(35)%
Nasdaq	35.5%	27.2%	11.9x	(38)%
Deutsche Boerse	22.1%	16.4%	11.9x	(42)%
London Stock Exchange	47.1%	24.4%	10.8x	(53)%

When posed with such wide a divergence between business results and stock performance, one must analyze the sentiment to find the reason. There you find an overwhelming belief that, for many rationales (e.g., a slowing economy, the de-leveraging of financial intermediaries, continuously eroding consumer confidence, etc.), exchanges will experience a diminution in trading activity. We disagree with this conclusion. Aside from the objective evidence that the opposite is occurring, here are but a few of the many reasons why:

There are many types of patterns that exist in trading; for example, there are pension funds that tend to make redemptions on certain days of the month for operational reasons. Therefore, someone might observe that sales seem to occur on a certain day of the month. Or, the corporate sponsors of pension funds might decide to make contributions on certain days of the month for purely operational reasons. There are individual investment advisors with trading desks that might have a rule that a trade for a DVP account must be placed before a certain hour, because it is more complex to settle.

Historically, there were always people who would notice such patterns and trade against them. However, today's technology makes it possible, if one is astute, to notice many more patterns. It is not something that Horizon engages in, but we will give an example. There is a time-honored technique called running-the-stops. When traders who employ this technique become aware of managers holding shares that operate with stop losses, they might short those shares to drive the price down enough to trigger the stop losses. Once the stop losses are triggered, the resultant selling creates more supply, the price goes down and the short sellers realize a profit.

Historically, if one were interested in the holdings of an investment advisor, the document to examine would have been the 13F Report, which investment advisors are required to file with the Securities & Exchange Commission within 45 days after the end of each quarter. One who studied the 13F to look for suitable candidates for a running-the-stops strategy would have to be aware that the data would have become very old and might be inaccurate. Consider the difference today when, during a trading day, an advisor might make an appearance on CNBC and, when asked his or her investment philosophy, might assert to the world that he or she employs stop losses for risk control and then go on to name the current positions.

There are now technologies for gathering market information and acting on it very rapidly. It is only a minor example of a plentitude of possible patterns that might exist. As a matter of fact, daily trading, when viewed in several-minute increments, has the characteristic of being bounded by the limit orders on the buy side and sell side for a couple of minutes. They remain within a narrow range either until orders are withdrawn or new orders are placed that alter the supply and demand balance to create a new dynamic equilibrium in some other range.

Before computers, traders did not have the means to observe these patterns, but now they do. Allied to this is the technology to create and execute trade instructions in fractions of a second, whereas historically minutes or hours might have elapsed. As a result, it should surprise no one that the volume in virtually every asset class continues to rise. Modern technology makes it possible to observe and act upon patterns in a very different way than was possible just a handful of years ago.

There is a lesson to be learned for anyone who looks at financial services stocks and improperly concludes that weakness in the economy must necessarily lead to a diminution of trading. We do not believe that to be at all the case. Instead, we believe that the inability to forecast what might happen in financial markets and economies leads people to engage in more short-term trading, not less.

An entirely different mode by which exchanges benefit is the increasing variety of derivatives that permit businesses to hedge their costs and risks. These are not speculative trades but, rather, improved tools. A U.S. business incurring costs or generating revenues overseas must make use of whatever mechanisms it can to hedge currency, interest rate, energy and other exogenously variable costs and risks. The variety of critical inputs for which large enterprises require insurance can be entirely esoteric to the average investor, yet no less important for being so. For instance, importers and exporters must protect against shipping costs and capacity availability that have become volatile beyond all historical norms as international shipping demand patterns change (with the advent of China and India as importers of large quantities of raw materials). As a consequence, exchanges that trade derivatives related to marine transport pricing and availability were direct beneficiaries of the volatility and turmoil in this as well as all of the above-mentioned sectors during the past year. We do not believe that the trading volumes of the exchanges will revert to a presumptive mean; rather, they are intensifying based upon real-world need and economic expansion, to new means. The exchanges continue to be among the most intriguing investment opportunities we have ever analyzed.

What If We're Wrong? – A Provocative Proposal

Now, some might ask what happens if you are wrong on one of these issues? What if you are even wrong on much of it, because that can happen? We invite you to read from an essay Murray Stahl wrote some years ago, called "Can a Bad Portfolio Manager Beat the S&P?" It was excerpted in last quarter's commentary and available on our website (www.hamincny.com). An exercise based upon that essay might go as follows :

> A portfolio manager buys 20 stocks, makes them 20 five-percent positions. Next morning, 10 of those companies file for bankruptcy – they are worthless. Of the

> remaining ten positions, eight of them at least go up in value, but only as much as the S&P 500 Index. The remaining two beat the S&P. Even with that happening to you, if you can be disciplined enough to hold that portfolio, you are going to enjoy outstanding long-term returns. You will not feel good in the first quarter or year or even first few years, but you will enjoy significantly positive returns over time. It sounds crazy. Yet as bad as that is, losing 50% of your money on the first day, the two good companies you have -- the two companies that will beat the S&P -- by definition are now 20% of your portfolio. In the fullness of time, the portfolio must come to reflect their superior position, their superior attributes, and the returns of the portfolio will ultimately converge with the returns of those two stocks. So now, even if you found only two that could beat the S&P and everything else was rotten, just leave it alone and you will prosper. In this extreme example, if one stock were to appreciate at a 25% rate, the 2nd at a 30% rate, the portfolio would outperform in about year 10.

We by no means expect to be subjected to such a scenario in the portfolios. This exercise simply illustrates that an investor can still succeed under these draconian circumstances if one respects the discipline of long term investing, which is to allow the power of compounding to actually be expressed. In fact, it is one of the important guidelines of Horizon's Investment Philosophy. Once comfortable with a determined allocation to a position (a decision that can take years) we must be sufficiently disciplined to not trade and to leave it alone. When faced with altered circumstances, we analyze the relevant details in an effort to determine whether these issues are transitory or permanent. If we remain comfortable with the risk/reward scenario, we accept the volatility. As the portfolios mature, the best positions become the largest positions, and vice versa. One must have the courage, or perhaps more accurately, understanding, to leave it alone. It should be mentioned that we really are timid by nature, some would say "perennial bears," but we understand that to engage in the natural human reflex to run and react to the ever emotional market, is to make mistakes and miss opportunities. Discipline and patience are without a doubt the most challenging aspects of our investment process.

All of that said, the bottom line is that our portfolios are down. Can they go down some more? The answer is yes. Is Horizon going to react and trade the portfolio? Not as long as the fundamentals and prospects for future earnings remain sound. Horizon will wait for the risk premium to change, albeit one cannot know when that will occur, which is an almost intolerable challenge to most investors. When it does change, though, it will be suddenly and rapidly without anyone knowing when until that change is well behind us. Thereafter, over time, when the risk premium gets to be too low, we will make appropriate changes into new securities and sectors for which the risk premium is high. Our interest lies where there is some change occurring that is highly questionable. There you will find us doing research. And when we find a circumstance in which we think the risk/reward proposition is appealing, Horizon will trust that research and take that opportunity, which is exactly what we have always done.

We appreciate your patience as investors and look forward to the years to come.

Disclosure:

For Existing Clients of this Strategy Only - Not for Prospect Use. This information is intended solely to report on investment strategies pertaining to present clients of Horizon Asset Management. Opinions and estimates offered constitute our judgment and are subject to change without notice, as are statements of financial market trends, which are based on current market conditions. Index returns do not reflect the deduction of fees, trading costs or other expenses and are for illustrative purposes only. The holding information presented is for a representative account and for illustrative purposes only. Actual account holdings and performance will vary depending on the size of an account, cash flows within an account, and restrictions on an account. Portfolio holdings are subject to change daily. Under no circumstances does the information contained within represent a recommendation to buy, hold or sell any security, and it should not be assumed that the securities transactions or holdings discussed were or will prove to be profitable. Composite results presented are gross of fees. Past performance is no guarantee of future results.