Pugh Capital Management INCORPORATED

3rd Quarter 2008 Market Outlook/Strategy

We are highly confident the U.S. will experience a recession that is deeper and more prolonged than our earlier gloomy expectations. The housing market is in a downward spiral, unemployment is on the rise and confidence in our financial system may be at a tipping point. Normally, our outlook primarily focuses on the economy. This quarter we will address market conditions and the growing financial system distress.

Over the past ten or fifteen years, vast fortunes were made by Wall Street firms, hedge funds, real estate investors and other entities by taking on ever greater risk via increased leverage positions. Now we are seeing the ugly unwind of this trade, with forced deleveraging tightening credit availability, causing distressed selling and pushing asset prices lower. Unfortunately, this rapid deleveraging process is still gaining momentum in our view, damaging every segment of the financial markets and economy.

The Government has stepped in, making decisions about which institutions should receive federal support and in what form. Bear Stearns received support and help brokering a deal, while Lehman did not. FNMA and FHLMC were taken over by the Government and their bondholders' government support was made stronger. However, their preferred and common stockholders were virtually wiped out. AIG received a government loan and time to manage asset sales in an orderly fashion. The JPM/WaMu/FDIC transaction was structured to protect depositors and treated bondholders as unimportant players. In the proposed Wachovia/Citigroup or Wachovia/Wells transaction, Wachovia senior and subordinate debt will be assumed by the winning bidder. This inconsistent application and lack of transparency in dealing with organizations, bondholders and shareholders increases market volatility and risks. Access to capital for financial institutions via new debt or equity offerings has become extremely limited for all but the few clear survivors. On the positive side the number of "at-risk" organizations has rapidly declined.

Lehman had a significant impact as it moved from high quality investment grade with debt outstanding of $34 billion to bankruptcy over a weekend. Institutional holders including money market funds and asset managers took immediate and significant devaluations. The Lehman bankruptcy also ensnared a number of prime brokerage account clients in a nightmare as many of their assets were commingled with Lehman's. These investors are now a part of the bankruptcy proceedings, and their assets are not available to them. The securities lending business is experiencing similar problems and is likely to be another area of deleveraging. The uncertainty surrounding protection of principal and the availability of funds is a tremendous risk and in some circumstances can threaten the viability of those investors caught up in the fray.

Institutional and consumer confidence is being eroded even in the perceived safe haven of money market funds. A major money fund "broke the buck" in September. Extreme market illiquidity resulted in the fund limiting redemptions and freezing assets. Another large mutual fund family closed down their money funds. This same phenomenon is occurring in the institutional space. The trustee for an institutional short term fund gave notice that they are liquidating holdings and distributing the assets. They are allowing only partial investors' withdrawals, with the remaining portion available as securities mature. In late September the market saw a rapid increase in money market outflows. Withdrawals reduce the availability of funding to municipalities, high quality industrials, and financial institutions through the commercial paper market, and raises financing costs exponentially.

It also causes distressed liquidations of short term securities, which increases the risk of more funds "breaking the buck". The Government has stepped in to guarantee money market funds, helping to stem the panic in that market.

Market valuations have significantly repriced and are at historically wide levels. Spreads look attractive based on any historical measurement. However, the market is faced with tremendous volatility and uncertainty. Investors in financial institutions' debt must factor in the probabilities of extreme outcomes. The stress in money market funds increases the likelihood of more withdrawals, which will accelerate deleveraging and continue to exert more pressure on spreads in short maturity securities. Meanwhile the Government has recognized the seriousness of current conditions and is adding liquidity, planning to buy securities and brokering deals. This reduces the risk of a more extreme scenario occurring. Our short term outlook for credit spreads remains negative based on expectations for continued deleveraging and a weaker economy. Yet spreads are undoubtedly attractive for the companies that we expect to remain viable, investment grade issuers. Ultimately, we believe these spread levels will provide strong returns.

Market risk is increasing as the deleveraging trend accelerates and the crisis becomes more global. We expect the bias of the corporate market to be toward wider spreads. Our strategy is fluid as we try to balance very attractive valuations with continued fundamental stresses and a weakening economy.

We would like to be more defensive than we are currently positioned and will look for opportunities to further reduce risk. One strategy that we will implement for new purchases is to reduce our single name target allocation to increase diversity of corporate holdings. For existing holdings we will continue to update our credit calls and proactively manage them while balancing existing valuations and market illiquidity. Individual credit risk is running at unprecedented levels and diversification should prove beneficial.

We expect mortgage and agency debt to outperform other spread sectors, but they will still experience volatility. Asset backed and commercial mortgage backed securities are at very attractive levels, but are also likely to experience spread widening as a result of deleveraging and deteriorating fundamentals. We will maintain a neutral to slightly long duration position relative to the Index.