Q4 2008 Quarterly Investment Commentary

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We hope that you enjoyed wonderful and relaxing holidays. Winter is an interesting season, bringing both adversity (cold weather, snow and rain), as well as beauty. Whether you are in the cold of the East and North, or the rain of the South and West, winter will give way to spring in the next few months, and with it renewal and new growth. Given all the uncertainty in the investment markets in 2008 we look forward to some springtime in the markets as well.

Fourth Quarter Market Performance

The fourth quarter of 2008 was an extremely difficult period for global economies and markets as the global credit crisis decimated liquid investment markets and home prices continued falling, leaving consumers and business unable or unwilling to spend. Fear of a steep global downturn and forced redemptions by banking institutions and hedge funds drove equity prices lower. Dramatic drops in the price of oil crushed commodity investments. REITs, which had held steady for the first 3 quarters, dropped 38% in Q4 alone. Many bonds lost value, though they have historically maintained value in a down market. While the Lehman Brothers Aggregate Bond index finished positive by +5.1%, corporate bonds fell -2.1%, and high yield bonds lost -26.2%. Only US Treasuries and cash had positive returns as investors fled all other asset classes. For all of 2008, the S&P 500 declined -37%, with all other indexes near or lower. Large Cap Value fell -36.8%, Large Growth -38.5%, Mid Cap -41.4%, Small Cap -33.7%, Emerging Markets -52.7%, Developed International -44.1%, Commodities -35.6%, and REITs -37%. Diversification, the fundamental foundation for modern portfolio theory, was ineffective in this crisis period as asset classes such as commodities and REITs that historically perform differently than equities did not during 2008.

The Economy

The current economic outlook has not only the continued concern for the stability of the global financial system but now includes a broad concern for the future growth of the global economy. The economic news is as difficult as it has been in decades. Consumer confidence has fallen to the lowest level on record (38, down from 44 in November), consumer spending has slowed (the first year that holiday sales were negative year over year), and business bankruptcies are increasing (58,000 bankruptcies through November 2008 vs. 43,000 in 2007). The jobless rate is climbing and consumers are worried about employment and corporate earnings.

Offsetting this negative news are some positives. Energy costs are down sharply, bringing gasoline and heating oil costs down to several year lows for consumers and businesses. The Fed is actively buying mortgages and the current rates for consumers with good credit are the lowest in years (30 year fixed conforming rates are between 4.5% - 5%). The Federal Reserve has lowered interest rates to 0% - .25% to stimulate the economy. Inflation is not a current concern as prices are actually falling, not rising. The incoming Obama administration is pushing a stimulus package exceeding $800B to be enacted soon; this will both lower some tax burdens while increasing spending on infrastructure. This fiscal stimulus will help our weak economy.

2009 Outlook

With the memory of 2008 fresh in investors' minds, it is sometimes difficult to see the "forest through the trees." Our expectation is for continued volatility in markets and a deep recession that will move toward slow growth late in 2009. The depth of some asset class declines will provide great opportunities for long term investors to profit on the rebound, while near-term volatility will likely continue to challenge our investors' emotions. Beyond 2009, we expect to experience several years of economic growth that is below the historical trend as consumers adjust to the new "responsibility" reality in which they finally have to reduce debt levels and increase savings. Since the 1980s we, along with many market experts, have been wondering when the growth in household debt would have to slow or reverse; it has taken 20 years, but it seems the time has come. We may also see an extended period of time in which markets are volatile with sharp surges up and down as we experience this slower economic growth trend. If this environment exists for a while as expected, we believe there will be times to capture returns, and we will continue to tactically tilt our portfolios as situations and opportunities present themselves.

We hope our Winter of (Market) Discontent is mainly over (although January has not been nice), and look forward to spring bringing forth new life in both the natural and investment worlds. While certainly not as predictable as the seasons, we will see the investment markets rise solidly at some point in the future. We wish you and your families a good 2009, and look forward to conversations and other ways that we can be of help.