



CAPITAL MARKETS OUTLOOK
The Economy ♦ Fixed Income ♦ Equities

PERFORMANCE AS OF: 9/25/2008	September to Date	Year To Date	12-MONTH RETURN
Strategic Growth Portfolio	-6.96	-14.19	-14.11
Russell 1000 Growth	-7.79	-16.85	-16.81
Strategic Value Portfolio	0.92	-13.14	-16.50
Russell 1000 Value	-4.21	-16.11	-20.41
S&P 500 Index	-5.59	-16.35	-18.61
MSCI EAFE Index	-6.30	-22.52	-22.14
Lehman Inter Govt/Credit Index	-1.52	0.79	3.95

OVERVIEW: Too Big To Fail -- Moral Hazard

Conservative pundits have warned that the process of easy credit, risk taking, financial innovation, failures that result in more easy credit or bailouts, risk taking, more innovation, failure, etc. are unsustainable in the long run because repeated bailouts or easy credit create moral hazard. “Moral hazard arises because an individual or institution does not bear the full consequences of its actions, and therefore has a tendency to act less carefully than it otherwise would, leaving another party to bear some responsibility for the consequences of those actions” (Wikipedia). Moral hazard in turn can trigger the law of Unintended Consequences (UC) which states that actions of people—and especially of government—always have effects that are unanticipated or “unintended.” Adam Smith’s “invisible hand” is an example of a positive economic UC. The current financial mess is a UC of the belief in too big too fail and it has provided a challenge to our system. A recent article in the NYT further summarizes our current predicament: “The law of unintended consequences is what happens when a simple system tries to regulate a complex system. The political system is simple, it operates with limited information (rational ignorance), short time horizons, low feedback, and poor and misaligned incentives.”

This month has witnessed an unprecedented number of financial events that will forever change the face of the credit and banking markets in the U.S. and around the world. The U.S. financial system last week was rocked by the biggest crisis since the 1930s—and the federal government responded with a multi-pronged intervention that is the most sweeping since the New Deal.

Over the course of just three days, Americans were shaken to see venerable investment bank Lehman Brothers Holdings file for bankruptcy protection, Merrill Lynch abruptly sell itself to Bank of America and the U.S. hurriedly launch an \$85 billion bailout of American International Group, one of the world’s largest insurers. Just one week earlier, the government had bailed out mortgage giants Fannie Mae and Freddie Mac, insisting that shareholders not benefit.

To summarize these important events, the following timeline will serve to recap and attempt to explain, at least in brief, what took place:

- Sunday 9/14--Merrill Lynch agrees to be purchased by Bank of America. Ten banks create a \$70 Billion borrowing facility. Lehman Brothers declares bankruptcy after would-be suitors decline purchase in total and the Government rules out a rescue. A total surprise given that Lehman had access to the FED funds through the FED’s discount window. Lehman’s bankruptcy filing was telling.... Lehman simply did not have sufficient quality collateral to present to the FED for a loan. Lehman’s bankruptcy is also rumored to trigger a “null and void” in their “derivative” and credit default swap arrangements.
- Monday—Insurance giant AIG suffers credit-rating downgrades and shares plummet. They seek as much as \$70 B from the government. Behind the scenes, the Fed and Treasury study an AIG bailout.
- Tuesday—Reserve Primary Fund, the oldest money market fund, breaks the buck as shares fall below \$1 NAV due to Lehman exposure. The U.S. government seizes control of AIG in an \$85B bailout by a loan with an interest rate of

over 10% and taking 89% of the stockholders' equity. The Fed keeps key interest rates unchanged at their scheduled meeting, and some global equity markets suspend trading as prices plunge.

- Wednesday—Morgan Stanley puts itself in play. Putnam closes and liquidates its Prime Money Market Fund. The flight-to-quality into 1-month Treasury Bills sends yields into negative territory. The SEC rules to crack down on short selling. In three days the FED has injected hundreds of billions of cash into the financial system and still the federal-funds rate went crazy by repeated spikes to high levels, later found to be caused by \$144 billion in withdrawals from money markets and the resultant \$50 billion shrinkage in the commercial paper market.
- Thursday--\$78.7B is withdrawn from money market mutual funds and the price of gold soars. The FED Chairman Ben Bernanke and the US Treasury Secretary Hank Paulsen recognized that the markets were seizing up and put in place a massive bailout proposal of \$700 billion to present to U.S. lawmakers. The proposal creates a mechanism to take bad assets off financial companies' balance sheets, similar to the RTC, which addressed the savings-and-loan mess several decades ago. The FED also proposes to insure money market mutual funds in an effort to stem redemptions. Together, these sweeping interventions are the largest since the New Deal.
- Friday—The bailout news on Thursday causes shares in equity markets to rally. Even financial stocks like Citibank and Bank of America, soar. The Treasury and the Fed moved to bolster money-market mutual funds.
- Sunday 9/21-- Goldman Sachs and Morgan Stanley asked the FED to grant them a charter as a Bank Holding Company and this was approved in an emergency meeting of the Board of the Federal Reserve. An extraordinary event in that the biggest of Wall Street houses were taking refuge in government **regulated** entities. Effectively saying the risks were beyond their means.

The common thread to all these events is that financial institutions or participants are being forced to de-leverage (place assets for sale or sell outright) as prices continue to weaken. The FED is providing a bid to these assets by its proposed actions that must be approved by Congress and ultimately blessed by the Court. The process of selling will end when long-term valuation and credit availability create equilibrium and prompt investors to buy. In the interim, financial institutions must clean up their balance sheets of these sour investments. The process will take time because even good news like Buffett investing in Goldman Sachs has its UC. In this case, the 10% rate on his preferred investment with a free equity kicker has raised the bar on what an investor should ask for to invest in companies of lesser quality.

Now is a good time to revisit your risk tolerance and objectives. A list of considerations follows:

- What is the purpose of the funds being invested?
- Has that purpose changed?
- Has the time horizon changed?
- Has your risk tolerance changed?
- Has your need for short-term withdrawals changed?

If nothing has changed, then, as difficult as it may be, continue your investment strategy and do not waiver or take short-term actions that will hurt long-term outcomes. Your portfolio is well diversified, and we'll get through this market cycle as we have gotten through others in the past.

If something has changed with regard to the above questions, please let us know, and discuss with your advisor what effect, if any, the change might have on your investment objective.

ECONOMIC COMMENT

While it will not be confirmed until October or November, it is possible that the economy contracted during the third quarter this year. This would come as an unexpected shock to many since growth was so strong in the prior quarter ended June 30. We learned last month that the economy grew at an annual pace of 3.3% for that three-month period, on the strength of consumer tax rebates that were spent between April and July. The employment picture continues to weaken since the beginning of the year as job losses through August have totaled over 600,000. It is generally believed that jobs need to grow an average of 100,000 per month to absorb increases in the work force. Even more troubling is the jump in the unemployment rate to 6.1%, the highest level recorded since June 2003, from July's level of 5.7%. Since employment and consumer spending are linked, we look for a re-evaluation of spending patterns going forward and a reduction in stimulus from the consumer sector. Retail sales fell in July and August for the first time in several months on slumping auto sales, declining home and asset values. A surge in exports during the second quarter contributed to our economic strength. However, outside of trade, most other indicators show signs of deterioration. Leading economic indicators posted back-to-back negative numbers in July and August, and the figures going back to the beginning of the year were barely positive. The housing sector continues to remain in free-fall with no end in sight, while the industry's statistics remain very depressed. Pending homes sales, housing starts, building permits and existing home sales have all contracted

during the summer while the industry continues to search for a bottom. Many previous recessions have commenced with a weak housing market. The government's efforts to stabilize the financial markets, especially with the proposed \$700 Billion package, will go far to alleviate fears. However, we are skeptical that the combined efforts of our leadership will pay dividends. If they do, we may be paying the price for many years to come.

FIXED INCOME COMMENT

In the third quarter, the fixed income market resumed a trend that had begun in 2007 and continued throughout much of this year. The "flight to quality" was back in full force as deteriorating credits were exposed, Lehman Brothers declared bankruptcy, bailouts were announced and even the venerable Federal National Mortgage Association (FNMA) and Federal Home Loan Mortgage Corporation (FHLMC) had to be supported by the federal government. The Federal Reserve may have reached a cyclical bottom in their intervention, although the futures market is alluding to the possibility that lower rates in the future should not be ruled out. The Federal Open Market Committee (FOMC) met this month and abstained from changing interest rates. However, into 2009, the chance exists that the Federal will either hold rates constant or lower them by as much as 50 basis points. The concern is the tradeoff between inflation brought on by higher food and energy expenditures versus the potential deterioration in the economy from the erosion in market and asset values plus higher unemployment. The consumer price index has risen 5.4% for the past 12 months and even when adjusted for food and energy, the number is still 2.5%, far above the Fed's desired target limit. The Fed is faced with a difficult task of finding a balance between inflation control and economic stimulation. Given this, we would continue to recommend a duration neutral position versus benchmarks and a maximum maturity in new, high quality investments no longer than three years. Investors must be diligent in selecting any corporates to purchase and may want to limit investments to Government and Government Agency securities and high quality municipal bonds, as they become available. (Please see the Finance Section in this quarter's Capital Markets Outlook for more information).

EQUITY COMMENT

Large Cap Growth Strategy - We believe the latest government actions in rescuing Fannie Mae and Freddie Mac along with the proposed mortgage bailout represents a reflationary strategy. To capitalize on this we have added to our positions in energy and materials and we expect to further overweight the energy sector as opportunities present themselves. We continue to emphasize a defensive portfolio sector allocation and that has helped our large cap growth process continue to outperform on a one year and year-to-date basis. As 2008 has progressed, our sector allocation has become a larger factor in our relative outperformance. Overweights in energy, health care and consumer staples stocks, as well as underweighting consumer discretionary and utilities has accounted for a little over half of our outperformance. Although the overall economy has held up better than expected, the latest market volatility indicates that further weakening may take place. New positions in ITT Educational services and Kroger were established while we eliminated our holdings in Coach and Franklin Resources with this scenario in mind.

Overall our discipline has guided us to emphasize larger capitalization companies with greater global economic exposure and the ability, if needed, to more easily tap credit markets. We continue to believe that smaller companies will continue to suffer as long as the dollar remains relatively weak and the credit market environment continues to tighten.

SECTOR COMMENTS

Finance - Unquestionably 2008 will go down in the history of the U.S. Capital markets as the most tumultuous year since the Great Depression. Recently passed legislation along with a concerted public desire to increase government regulation marks a sweeping reform to the financial services industry. The Government's bailout brigade started with Fannie Mae and Freddie Mac which could total \$200 billion, moved next to AIG with an \$85 billion loan, and then a proposed Government entity to purchase up to \$700 billion of distressed assets at a price to be determined. This would inject fresh capital into the banking industry to be made available for qualified borrowers. While the details are still being debated in Washington, the proposed concept has placed a backstop or floor in the financial markets. Therefore we feel this announcement marked a bottom for financials, which have bounced sharply off their lows.

Our position is the de-leveraging process will continue in financial markets for quite some time. The typical bank model for doing business will change and several institutions will be looking for a partner, i.e., Bank America with Merrill Lynch. Most banks' will be working to recapitalize their balance sheet. This is exemplified with Goldman Sachs and Morgan Stanley forming bank holding companies in order to accumulate deposits and gain access to the Fed's discount window. Also, during the de-leveraging phase, the Fed will force weaker banks to merge with stronger financial institutions. At the end of this process the winners will be those institutions that attract low cost and stable deposits, maintain competitive interest margins with quality loans, and generate growth in non-interest income from investment

management, trust, and brokerage fees. Thus, we favor, asset managers, custody and securities processing banks and insurance sub-sectors; such as, J.P. Morgan, Bank of New York, and Aflac.

Finally, we are looking for credit spreads to return to more normalized levels and a stable real estate market before we significantly overweight financials.

Healthcare - We continue to be overweight Healthcare for its growth leadership and defensive characteristics with a concentration in biotech. We are currently underweight pharmaceuticals, facilities and managed care sub-industries. The facilities and managed care sub-industries have been severely impacted by politics and have struggled to keep pace. Drug stocks are showing impressive strength and may provide a defensive opportunity for higher dividend yields.

Consumer Staples - Until we see more evidence of a bear market bottom or improving leading economic indicators, we remain defensive and overweight Consumer Staples. The sector has held true to its defensive nature, outperforming the S&P 500 and the other the sectors. We are concerned about valuations in the sector as well as continued profit margin pressure because of rising input prices and intense competition. Companies that are focused on premium products and are able to get consumers to trade-up to higher margin products may have the edge over the next twelve months. Another focus is those firms that consider small niche acquisitions that allow for expansion into a new geography, channel or category.

Consumer Discretionary - Strength in the dollar and oil weakness continues to fuel a rally that started in mid July whereby the sector has outperformed the S&P 500 since the end of the end of the second quarter. However, rising unemployment, falling home prices and net worth, tight credit, and higher food and energy a cost crowding out discretionary spending keeps us cautious on the consumer sector. Earnings expectations have been lowered substantially and the consensus growth rate has dropped from 24% to -12% for the year. The sector typically is a strong performer following a series of rate cuts and before economic growth accelerates. We will look to move from an underweight position when we see more evidence of a market bottom.

Technology - The Technology Sector has not been immune to the ongoing credit crisis with the NASDAQ Composite down -17.85% year-to-date as of September 22, 2008. Even good news such as Microsoft's (MSFT) announced \$40 billion share buy-back and 18% increase in its' dividend or Oracle's (ORCL) recent upside earnings surprise on an 18% rise in sales have not increased investors' optimism for the sector. The semiconductor group has suffered as corporate purchasers are holding less inventory and sales are weakening for every day used consumer electronics products that use semiconductors. We are maintaining a market weight in the sector and continue with our defensive posture in Large-Cap names with strong balance sheets, little to no debt and high market shares. This is an old theme, but should serve our clients' well in the coming months ahead.

Energy - The year has been quite volatile for oil and natural gas prices and the energy sector. We have recently experienced a dramatic correction in the stocks within the sector as demand declined resulting from the global economic slowdown. We are planning a shift to an overweight position as we believe the combination of historically elevated oil prices, low valuations, and a positive technical outlook will lead to a resumption of broader market out performance. We recommend staying diversified in the various subsectors.

Industrials - The slowdown of the U.S. economy has severely hurt most of the stocks in the sector. A weak dollar had resulted in strong international sales, which offset the domestic weakness. But, the recent rebound in the dollar, due mostly to the economic weakness spreading globally, resulted in a major downturn for the Industrial Sector. It now appears the dollar is again weakening and many of the stocks appear oversold. We will continue with a "market weight" position.

Materials and Utilities - We are currently underweight utilities and although we feel the earnings cycle for materials has peaked, we continue to favor the agricultural themes. With global growth slowing this will lead to a decrease in demand for raw materials. Also, downward pressure has been placed on commodity prices due to hedge fund selling and liquidation. However, the basic global demand for food remains intact, and the agricultural industry is striving to increase crop production per square foot with special fertilizers and genetically engineered disease resistance seeds. A favorite name in this group is Potash Corporation of Saskatchewan.