

## **Quarterly Review and Outlook – Third Quarter 2008**

As the credit crisis that began in earnest this past spring continues to evolve, 2008 is shaping up to be an incredibly difficult year for the markets. The markets declined dramatically during the quarter and the selling pressure has intensified during the month of October. Through September, U.S. large cap and mid cap stocks are down 20% while U.S. small caps have outperformed on a relative basis but are still down 10%. After outperforming their domestic counterparts for the first half of the year, the international benchmarks declined significantly during the quarter. The MSCI All Cap World Index excluding US was down 22% and MSCI Emerging Markets Index was down 27% during the quarter. For the year, those benchmarks are down 30% and 35% respectively.

Bonds and hedge funds have both outperformed the equity indices, but both are having trouble generating positive returns. For the year, the Lehman Aggregate Bond Index is up 0.6% and the Lehman Intermediate Government/Credit is up 0.2% while municipal bonds have declined 3% for the year. Hedge funds have been widely publicized for their lack of an adequate hedge in this market, however the HFRI Fund of Funds Composite index has declined half as much as the broad market. We believe hedge funds have a place in portfolios and the recent volatility has made it extremely difficult for anyone to earn returns. The following quote from Stark Investments is worth considering:

“There is no good hedge for a liquidity crisis. If you own something that somebody else needs to sell, it’s going down and taking your mark-to-market with it. ...The only real “hedge” here is to position the portfolio to be able to weather the liquidity storm.”

Within this environment that has been driven by a general lack of confidence in the global financial system, we are being asked three questions that I would like to address in this letter. First, what has happened and why is it causing the market to decline so dramatically? Second, what is our outlook for the economy and markets? Third, should we make any changes to our portfolios?

### **What has happened?**

To suggest that we completely understand the forces that have gotten us to this point would be a gross overstatement of our abilities. The global financial marketplace has become exceedingly complex over the last two decades making transparency extremely difficult. While our explanation will certainly be incomplete, in its simplest form we are experiencing the effects from declining house prices over the past two years. It was the declining house prices that forced the subprime mess that set off a chain of events we are seeing today. The subprime butterfly flapped its wings and a financial tsunami erupted around the globe.

As home prices continued to decline, the subprime mortgage problems moved into Alt A mortgages and eventually to prime mortgages, home equity, credit cards, and autos.

As these loans soured, their values were written down on balance sheets which required financial institutions worldwide to delever their balance sheet by selling off assets or raising additional capital. As this downward spiral continued, the amount of leverage and risk inherent in the financial system became apparent and a crisis of confidence in the financial markets took hold and the credit market froze. The seizure in the credit market forced the failure or bailout/brokered sale of Lehman, AIG, Fannie Mae, Freddie Mac, Washington Mutual, Merrill Lynch, and Wachovia.

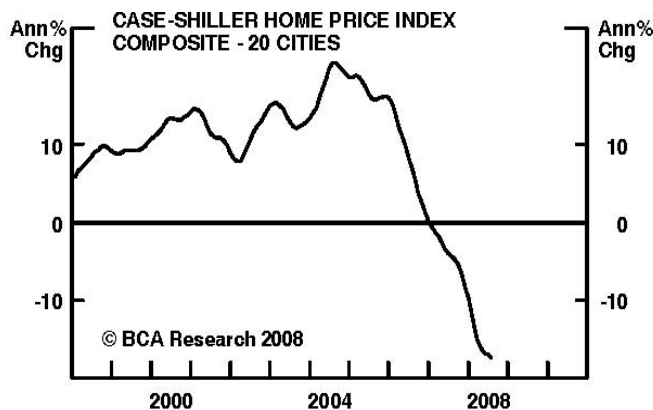
The market has reacted to this and in our view priced in a long, severe global recession and the likelihood of further bailouts and failures of financial institutions around the world.

### What is our outlook?

Our long term outlook remains optimistic with a fair dose of caution sprinkled in. It has become apparent to us that a significant action was necessary from the Fed and Treasury as well as the rest of the world. We are pleased that they have taken aggressive action and it is likely that more is necessary. While we embrace capitalism and letting the markets work, sometimes intervention is necessary and this is one of those times. This problem appears too big to work itself out without irreparable harm to the US economy. Because of this aggressive action, we believe confidence in the financial system will be restored and we will avoid a long and severe recession **assuming the housing picture brightens.**

The actions taken to date include aggressive Fed easing, Fed support to non-bank institutions, fiscal stimulus, a \$700 billion bailout, and a coordinated easing of global central banks. In the coming days, we expect the Treasury will make direct investments in financial institutions following the lead of other governments around the world. We would also be in favor of temporarily changing the mark to market accounting standards to ease the spiraling affect of declining asset prices. These are incredibly positive developments that should ease the strains over time in the credit markets and get capital flowing. A functioning credit market is inextricably linked with a sound economy.

As we move beyond the immediate crisis, for the economy to start growing again we believe that housing prices must stabilize. Following is a chart of the S&P/Case-Shiller 20-city home price index:



Considering the supply of unsold homes, availability of credit, and the recent volatility in the equity and fixed income market we see housing slowly recovering. Another aspect of the declining price environment is what impact that has on the consumer as well as businesses. The likely reaction is to become more cautious on spending as they become more concerned regarding the economic environment.

In summary, our view is that an economic recovery will take some time. The credit cycle continues to evolve, deleveraging is underway but has a ways to go, and the consumer and businesses are likely reconsidering their opportunities and capital commitments. That being said, we believe there is value in the market and the market is oversold giving us, with time, an opportunity to experience a rebound from here. We have also spent a great deal of time looking “underneath the hood” at our managers and we see opportunity. We see numerous examples of value in our portfolios and we are optimistic, over time, these values will be recognized. Our managers believe this as well.

### What should you do?

We have suggested to you in recent weeks continuing to follow the investment principles that we believe are critical for achieving long term investment success: well thought out asset allocation with proper diversification, sticking to your investment plan, maintaining a long-term orientation, and resisting the urge to overreact to short-term issues facing the market. These principles will get us through challenging financial periods like we are experiencing today.

The following chart looks at bear market cycles vs. the subsequent bull markets as the economy recovers. You can see the average down period sees equities decline by 33% over 14 months. This current cycle has lasted 12 months and has exceeded the average decline. We believe this chart makes a great case for staying invested during difficult periods.

Bear Market Cycles vs. Subsequent Bull Runs					
Market Peak	Market Low	Bear Return	Length of Decline	Bull Run	Length of Bull Run
5/29/46	5/19/47	-28.6%	12	257.6%	124
7/15/57	10/22/57	-20.7%	3	86.4%	50
12/12/61	6/26/62	-28.0%	7	79.8%	44
2/9/66	10/7/66	-22.2%	8	48.0%	26
11/29/68	5/26/70	-36.1%	18	74.2%	32
1/5/73	10/3/74	-48.4%	21	125.6%	75
11/28/80	8/12/82	-27.1%	21	228.8%	61
8/25/87	12/4/87	-33.5%	3	582.1%	150
3/24/00	10/9/02	-49.1%	31	101.5%	60
Average		-32.6%	14	178.0%	68



One thing we are encouraging you to do is to think about asset allocation. We can advise you on what the proper asset allocation is for your goals and objectives, but this academic view ignores two things...comfort and peace of mind. Trying markets like we have experienced recently provide an opportune time to ask yourself whether your asset allocation allows you to sleep well at night. If you decide changes are necessary, we recommend not taking immediate action, but making any changes in a deliberate manner as the market gives us opportunities.

We want to leave you with one more quote that we borrowed from Centennial Partners. This summarizes quite succinctly how we feel at this very moment.

“Never before in our careers have we been so nervous about the short term,  
yet simultaneously so excited about the long term investment environment.”

We thank you for your business and look forward to speaking with you soon. As always, please do not hesitate to call us at any time with your concerns or questions.

Best regards,

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