

INVESTMENT COMMENTARY

A PUBLICATION OF LARRY THOMPSON & ASSOCIATES, INC.

3500 Oak Lawn Avenue, Suite 240 · Dallas, TX 75219 · 214-752-5430

<http://www.larrythompson.net>

Volume 12, Issue 1

1st Quarter 2008

The Markets

Index	Quarter	Year to Date	Trailing 1 Year	Trailing 3 Years	Trailing 5 Years	Trailing 10 Years
<u>Domestic Equity (Large Cap)</u>						
Russell 1000	(9.48)	(9.48)	(5.40)	6.19	11.86	3.83
Russell 1000 Growth	(10.18)	(10.18)	(0.75)	6.33	9.96	1.28
Russell 1000 Value	(8.72)	(8.72)	(9.99)	6.01	13.68	5.54
<u>Domestic Equity (Mid Cap)</u>						
Russell MidCap	(9.98)	(9.98)	(8.92)	7.36	16.31	7.65
Russell MidCap Growth	(10.95)	(10.95)	(4.55)	7.77	15.20	5.15
Russell MidCap Value	(8.64)	(8.64)	(14.12)	6.57	16.77	8.16
<u>Domestic Equity (Small Cap)</u>						
Russell 2000	(9.90)	(9.90)	(13.00)	5.06	14.90	4.96
Russell 2000 Growth	(12.83)	(12.83)	(8.94)	5.74	14.24	1.75
Russell 2000 Value	(6.53)	(6.53)	(16.88)	4.33	15.45	7.46
<u>International Equity</u>						
MSCI World ex US	(8.69)	(8.69)	(1.29)	13.87	21.81	6.53
MSCI World ex US Growth	(7.84)	(7.84)	3.77	15.17	20.44	4.72
MSCI World ex US Value	(9.55)	(9.55)	(6.27)	12.49	23.06	8.09
MSCI Emerging Markets (Gross)	(10.92)	(10.92)	21.65	29.64	35.95	12.53
<u>Real Estate</u>						
Nareit Equity REITs	1.40	1.40	(17.38)	11.68	18.33	10.68
<u>Domestic Fixed Income</u>						
LB Aggregate	2.17	2.17	7.67	5.48	4.58	6.04

As we enter into the 2nd quarter of 2008, about the only positive comment we can make about the 1st quarter is that it is over. Although the problems with equity markets worldwide began last year, increasing bad economic news along with a number of unpleasant “surprises”, led to increasing downward pressure. Initially, investors seemed to only punish companies in economic sectors in which they felt were particularly vulnerable – sectors like Financials and Consumer Discretionary. Eventually, as fear got the best of many equity

Investment Commentary is a newsletter dedicated to the issues, trends, and strategies surrounding both the individual and institutional investor. It is published quarterly by Larry Thompson & Associates, an independent investment management consulting firm based in Dallas, Texas.

participants, investors began to simply pull money out of the markets, paying little attention to company name or industry group.

Clearly, there was no place to hide during the 1st quarter of 2008. The Russell 1000 (domestic large-cap equities) finished down 9.5% for the period, the index's worst quarterly showing since 2002. The Russell Midcap (domestic mid-cap equities) and the Russell 2000 (domestic small-cap equities) markets suffered as well, returning -10.0% and -9.9%, respectively. While investors may have initially sought out large-cap companies for safety, this would not last. Quickly, investors turned to U.S. Treasury securities as the only true safe haven, boosting the domestic bond market (Lehman Brothers Aggregate) to a healthy 2.2% return for the period.

Although the 1st quarter sell-off was broad-based, it was not spread equally across all economic sectors. We should remember that in a capitalization weighted index, the return of an economic sector *and* the sector's weighting in the index both play roles in the ultimate return of the index. For example, the worst performing economic sector of the Russell 1000 Index during the first quarter was Information Technology, down 15.0%. Unfortunately, IT was also the second largest sector in the index, representing 15.5%. The combination of IT's return and its large weighting yielded a *contribution* value of -2.5%, earning it the honor of being the biggest negative contributor to the index for the period. The other big negative contributor for the period was our old friend Financials. Financials was the largest segment of the index (16.8%) and turned in the third worst performance (-13.2%). This combination yielded a contribution of -2.2%. So, of the ten economic sectors in the Russell 1000 Index, Financials and Information Technology contributed almost 50% of the -9.5% return.

Just for comparison sake, Telecommunications Services was the second worst performing sector, down 14.5% for the period. However, the Telecommunication Services sector only represents 3.3% of the index and therefore only contributed a -0.5%

While market capitalization did not appear to matter during the period, style did matter. Value markets outpaced their growth counterparts across all size segments. As we have noted in the past, the whole "growth versus value" analysis is more about the indexes' sector makeup than it is about the "growth" or "value" label. For example, the Russell 1000 Value Index and the Russell 1000 Growth Index both contain the same ten economic sectors and the absolute returns of the sectors in each of the sub-indexes are usually similar. During the first quarter, Information Technology returned -14.6% in the R1000 Value Index and -15.0% in the R1000 Growth Index. However, IT has a weighting of only 3.1% on the value side, but has a weighting of 26.9% on the growth side.

Foreign equity markets fared no better than U.S. markets. In fact, our markets finished fourth among the 25 developed financial markets when viewed in local currency terms. Domestic participants in non-U.S. markets have benefited from a weakening U.S. Dollar for the past six years. Although our slumping greenback may not have appeared to help during the first three months of 2008, it actually did provide quite a bit of downside protection. The MSCI World-ex U.S. Index finished -14.0% in local currency terms, but was only down -8.7% in U.S. Dollar terms.

Emerging markets were a mixed bag during the quarter. The index itself lost 10.9%, but returns ranged from a low of -38.3% in Turkey to a high of 33.8% in Morocco. Latin America

was the best performing region, down only 1.4%. Most major emerging markets were negative. Brazil lost 5.0%, Russia lost 11.5%, India lost 27.0% and China lost 23.7%. The energy and materials stocks in Brazil and Russia did offer relative safety, but not enough to prevent losses.

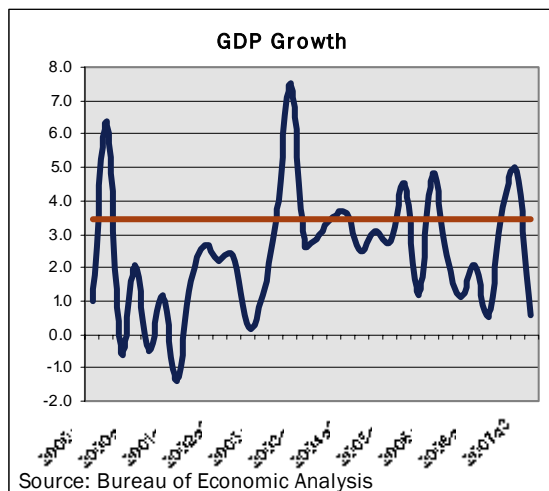
Real Estate Investment Trusts (REITs) are worth noting as equity REITs were one of the few positive market segments for the quarter. Equity REITs were up 1.4% for the period, but are still down over 17% for the trailing 12 months.

The Economy

The media has done an ample job of painting a bleak forecast for our economy and readers would be hard-pressed to find *any* positive forecast these days. While it is not our style to “follow the herd” and we would like nothing better than to be able to fashion an alternate view, it would be irresponsible for us not to tell it as we see it.

There has been much discussion as to whether we are in a recession or not, but it really does not matter. As readers may know, there is a technical definition of a recession, which is simply two or more consecutive quarters of negative GDP growth. Because the ultimate measurement of GDP for a given period is several quarters after the fact, recessions can be over before we can say for sure that one actually existed.

Although we may not be able to measure every economic statistic to second decimal point accuracy, the general picture is clear – economic activity continues to decelerate. There are problems on the home front and some may get worse before they get better.

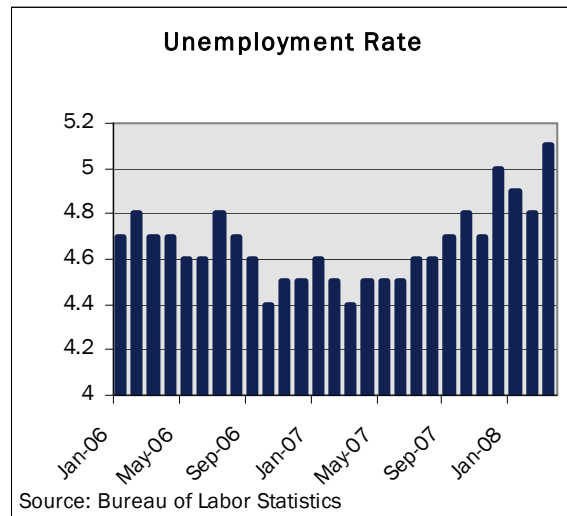


Besides the occasional positive spike, GDP growth in the U.S. has been low for the past several years. What initially appeared to be below historical average growth has now turned into possible recessionary or negative GDP growth. The year 2007 saw the two lowest quarterly GDP growth figures since 2002. During both the first and fourth quarter, GDP only managed to grow 0.6%. The year as a whole only saw a 2.2% growth, the lowest since the 1.6% growth in 2002.

We have focused on the consumer as having the single greatest impact on economic growth in this country – consumer spending represents about 70% of GDP. And, while the consumer has certainly done his and her part to keep our economy in an expansionary mode since 2002, real personal consumption expenditures (PCE) has been in a steady decline since August of 2007. Economists surveyed by Bloomberg predict that consumer spending during the first half of 2008 will advance at the slowest rate in 17 years. So, what is up? Why has the consumer decided to limit their “consumption”?

Employment

We can start with the fact that Americans have lost some 232,000 jobs so far this year. Employment losses have been the greatest in the manufacturing, construction and retail trade sectors. However, job losses have also been significant in the Financial sector. Unemployment stands at around 5.1%, but is predicted to increase to around 5.6% by yearend. It is an understatement to suggest that not having a job will have a very negative impact on spending.



Energy Prices

The impact of oil prices moving from around \$65 a barrel twelve months ago to around \$112 of late has probably not been fully felt by corporate America or the consumer. There is a bit of a tug-of-war where corporations are attempting to figure out just how much of this price increase they can pass along to consumers and just how much they might have to absorb. While the outcome is different with respect to specifics, neither scenario is good. If higher energy costs are passed along to consumers, the consumer will necessarily have less to spend on other goods and services or perhaps less to put away in the form of savings. If the corporation feels they have to eat the extra costs, this will result in lower earnings, which in turn can mean less funds available for raises or worse yet, result in layoffs. Pick your poison.

Disposable Income

Higher energy costs, gasoline prices in excess of \$3.45 per gallon, and skyrocketing food costs all serve to eat into consumers' discretionary spending. Borrowing against home equity has all but dried up, as well. While we were never fond of the idea of borrowing against one's home to purchase consumables, this practice was at one time widespread and helped support consumer spending.

The reality of borrowers being forced to stop using credit "cold turkey" may be creating a new monster. Loans from 401(k) plans and other retirement plans are increasing at an alarming rate. One group reported hardship withdrawals up 32% over just last year. Different plan providers report various numbers, but they all agree on one thing - the use of funds supposedly set aside for retirement are being used today. What might retirement hold for those who are invading these precious funds?

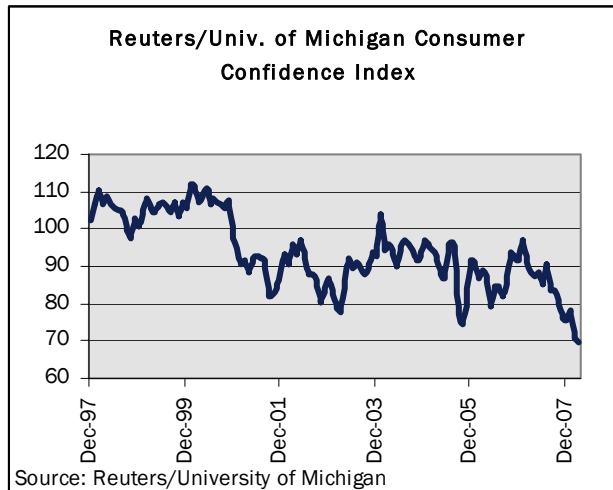
The Housing Market

According to an estimate by Moody's Economy.com, 8.8 million U.S. homeowners will have zero or negative equity in their homes by the end of March 2008. This represents a staggering 10.3% of homeowners. According to RealtyTrac, almost one million homes were seized last year - the highest ever and more than double the rate of 2006. Even

homeowners who did not rely on home equity to finance expenses, and may be at little or no risk of foreclosure, are feeling the stress associated with depressed home prices

Consumer Sentiment

Consumer confidence is at a 26 year low. Unemployment on the rise, the worst housing market in decades, out-of-control energy and food prices, and our financial markets off 10% this year and in some cases off twice that much from their highs – is it any wonder?



Perhaps the greatest factor contributing to investor and consumer sentiment is the fear of the unknown. For example, how exactly should one interpret the demise of a Bear Stearns – the fifth largest investment bank in the U.S.? Consider that the Fed orchestrated a deal literally over the weekend where JP Morgan would agree to acquire Bear at \$2 per share (later raised to \$10). To add some sort of perspective to this, consider that the company's stock had traded as high as \$159 per share during the past 12 months. While Bear Stearns may rank at the top (so far) as

far as financial meltdowns, they are certainly not alone. The list of top line financial institutions that have been forced to take massive write-downs and huge hits to earnings is long and impressive.

Dysfunctional Credit Markets

Much has been written about our dysfunctional credit markets and I doubt that I can add anything new. Although the circumstances of this credit debacle are somewhat different than those that came before and the financially engineered securities of today are beyond complex, the recipe for a “credit melt” seems to always have the same key ingredients.

Take one healthy portion of consumers. Look for the type who want more than they can really afford. Mix in an equal part of accommodating lenders. The lenders who are very shortsighted and are blinded by the prospect of earning huge fees work best. You will be able to recognize these people, as they will rarely bother anyone with those annoying questions like “Is there even a remote possibility that you will be able to pay this back?”

We are almost there. We just need somebody to package all of this stuff. Pardon the digression, but I am suddenly reminded of a comment that a very wise man once made. It went something like, “you can roll that corncob in as much powdered sugar as you want and it's never going to be a Twinkie”. Well, you know the rest – the borrowers are losing their homes, the lenders are dropping like flies and the brokerage firms and banks who packaged all of this junk are being forced to eat their own Twinkies – or whatever. Apparently, the banking crisis of the late 80s and early 90s that resulted in more than 1000 savings & loan banks to fail was just too long ago.

The Collapsing U.S. Dollar

The value of the U.S. Dollar has been declining for roughly six years now. Many domestic investors have benefited from this phenomenon by participating in foreign financial markets and profiting via the currency impact. U.S. exporters have also benefited from the weak Dollar, as this weakness makes domestic exports relatively more competitive.

It appears that there is a lot of “rethinking” going on with respect to the mighty Dollar. The U.S. imports a lot of oil these days and it is all priced in Dollars – ouch! Add to this, countries around the world that are seeing their export businesses suffer and are screaming about what to do about it.

Several things might happen. Certain countries may take aggressive steps to devalue their own currency – a measure they feel is warranted to save their export businesses.

We have been discussing a “more natural” economic scenario that might cause the U.S. Dollar to strengthen. Consider that the U.S. economy is not the only economy that is slowing. We are seeing similar problems in Europe and elsewhere. It seems that like Fed Chairman Bernanke, his counterparts across the pond would rather fight inflation than rescue an ailing economy. As readers may recall, Mr. Bernanke was very vocal early on about controlling inflation and gave little hint that he was particularly interested in becoming accommodative. Even today, the Chairman is criticized by some for not reacting sooner to our economic woes.

It seems that Jean-Claude Trichet, President of the European Central Bank (ECB) might be today where Mr. Bernanke was just a few months ago – attempting to keep interest rates up for inflation fighting purposes – and not particularly interested in accommodative monetary policies. One scenario that we have been discussing is as follows: We will recover from our economic downturn. When we do, the Fed may very well turn back to their favorite task of keeping inflation in check. Should inflation still be a concern, their weapon of choice could be a series of interest rate hikes.

Our thoughts are that this might occur at about the time Mr. Trichet might feel compelled to lower rates over yonder. What do you get when you raise rates in the U.S. and lower rates in the Eurozone? All else equal, you may very well get a strengthening Dollar. Although we are not to the point of recommending that our clients take any particular action at this time, we are having discussions just the same.

Corporate Earnings

The corporate earnings level of the S&P 500 has been suffering the past few quarters. Collectively, the operating earnings of the 500 companies in the index were 31% lower at the end of 2007 than they were at the beginning of the year. According to S&P research, first quarter earnings are expected to improve from fourth quarter, but still be 12% lower than they were at this time one year ago.

Obviously, times are hard for corporate America, or are they? When you break down the earnings of the index into economic sectors, the picture is not as bleak as it first appears. Of the ten GICS sectors in the S&P 500, only four reported negative earnings growth in the fourth quarter (consumer discretionary, financials, materials and utilities). Considering that financials alone reported earnings 143% less than the previous year, you realize that the overall earnings decline is really a decline in financial earnings. Financials were the only sector to report actual losses compared to simply lower earnings levels. S&P research indicates that first quarter financial sector earnings will be 66% lower than one year ago, but at least they will be positive. Other sectors expected to struggle include consumer discretionary, industrials, and materials, but none of them should struggle nearly as much as financials. The “fundamental” troubles in our markets still appear to be limited to a relatively small number of economic sectors. Unfortunately, the current markets are not paying much attention to fundamentals.

The Federal Reserve and Government Actions

Since September of last year, the Federal Reserve has been aggressively lowering interest rates. The Fed Funds rate has been taken from 5.25% to 2.25%. The effects of these lower rates is hard to judge. On the one hand, banks need to begin lending money again. This is what banks do. However, many banks are sitting on their proverbial hands, fearful to do anything – including lending to qualified borrowers. Clearly, the credit pendulum has swung from too lenient to overly restrictive.

The government hopes that the tax rebate stimulus package could have a much larger impact on our economy. Beginning next month, the Treasury will be issuing checks totaling \$150 billion or more to many Americans. If all goes as planned, this money will be spent immediately and could be a significant boost to our economy. It remains to be seen if this will actually happen. No doubt, some recipients will save these funds as a means to offset the declining value of their investments. Others may use these funds to pay down current debt. Although investing and debt reduction are both honorable uses, neither of these actions will benefit our economy, at least in the short run.

The problem with tax rebates, mortgage bailouts, or banking system bailouts is that someone has to pay for them – like people reading this commentary. The government has been running a large budget deficit for the past few years. We have been able to finance it cheaply because of help from China, Japan and other sovereign wealth funds, who have been content to buy our Treasuries at cheap rates and hold them while they lost value due to a falling U.S. Dollar. These countries have lent the U.S. a lot of money in the past few years and we expect them to continue to lend us money. If they do not, we may need to raise taxes or dramatically cut spending, a difficult option given the looming disasters of Social Security and Medicare. Raising taxes or reducing spending will reduce economic activity and make profitability more difficult for companies.

Conclusion

As I read back over this, it all sounds bleak. However, as we stated earlier, we have to call it as we see it and there are some real problems in our economy. Some of them may not be resolved overnight. For example, energy prices are high and may stay high. Housing is a big problem and it will take some time for our economy to work through this. However, there is

one belief that we hold and hold strongly. Our economy and our financial markets will survive. Economic slowdowns are not new and neither are market downturns. When we are in the middle of one of these periods, it always seems like “this is the big one” or “this one is different”. Well, they are *all* different to a certain degree, but we will make our way through this period. We have no doubt of this.

There is a good chance that even the most well diversified portfolio was down during the 1st quarter of 2008 and trailing 12-month returns could be in negative territory, as well. However, this downturn comes on the heels of five straight positive years, three of them up by double-digits. As most investors are well aware, it is difficult, if not impossible, to construct a portfolio that can provide a long-term required rate-of-return without suffering intermittent setbacks. Long-term investors appear to be “sticking to their guns” and in some cases, using this “correction” to opportunistically do some bargain hunting. Remember, financial markets have a history of rebounding well before our economic troubles are behind us and our equity markets are actually somewhat “cheap” now by many historical measures.