

INVESTMENT COMMENTARY

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The Markets

2008 was a year that will not be missed. Equity markets around the world plummeted as the banking sector faced its biggest challenge since the 1930s, which led to a worldwide economic recession. The table below shows how major financial market indexes have performed.

Index	Quarter to Date	Year to Date	Trailing 1 Year	Trailing 3 Years	Trailing 5 Years	Trailing 10 Years
<u>Domestic Equity (Large Cap)</u>						
Russell 1000	(22.48)	(37.60)	(37.60)	(8.66)	(2.04)	(1.09)
Russell 1000 Growth	(22.79)	(38.44)	(38.44)	(9.11)	(3.42)	(4.27)
Russell 1000 Value	(22.18)	(36.85)	(36.85)	(8.32)	(0.79)	1.36
<u>Domestic Equity (Mid Cap)</u>						
Russell MidCap	(27.27)	(41.46)	(41.46)	(10.68)	(0.71)	3.19
Russell MidCap Growth	(27.36)	(44.32)	(44.32)	(11.78)	(2.33)	(0.19)
Russell MidCap Value	(27.19)	(38.44)	(38.44)	(9.98)	0.33	4.44
<u>Domestic Equity (Small Cap)</u>						
Russell 2000	(26.12)	(33.79)	(33.79)	(8.28)	(0.93)	3.02
Russell 2000 Growth	(27.45)	(38.54)	(38.54)	(9.32)	(2.35)	(0.76)
Russell 2000 Value	(24.89)	(28.92)	(28.92)	(7.49)	0.27	6.11
<u>International Equity</u>						
MSCI World ex US	(21.15)	(43.56)	(43.56)	(7.25)	1.91	1.18
MSCI World ex US Growth	(20.96)	(42.88)	(42.88)	(6.28)	1.83	(0.87)
MSCI World ex US Value	(21.36)	(44.29)	(44.29)	(8.32)	1.90	3.00
MSCI Emerging Markets	(27.56)	(53.18)	(53.18)	(4.62)	8.02	9.31
<u>Real Estate</u>						
Nareit Equity REITs	(38.81)	(37.75)	(37.75)	(10.85)	0.90	7.41
<u>Domestic Fixed Income</u>						
Barclays U.S. Aggregate	4.57	5.24	5.24	5.51	4.65	5.63

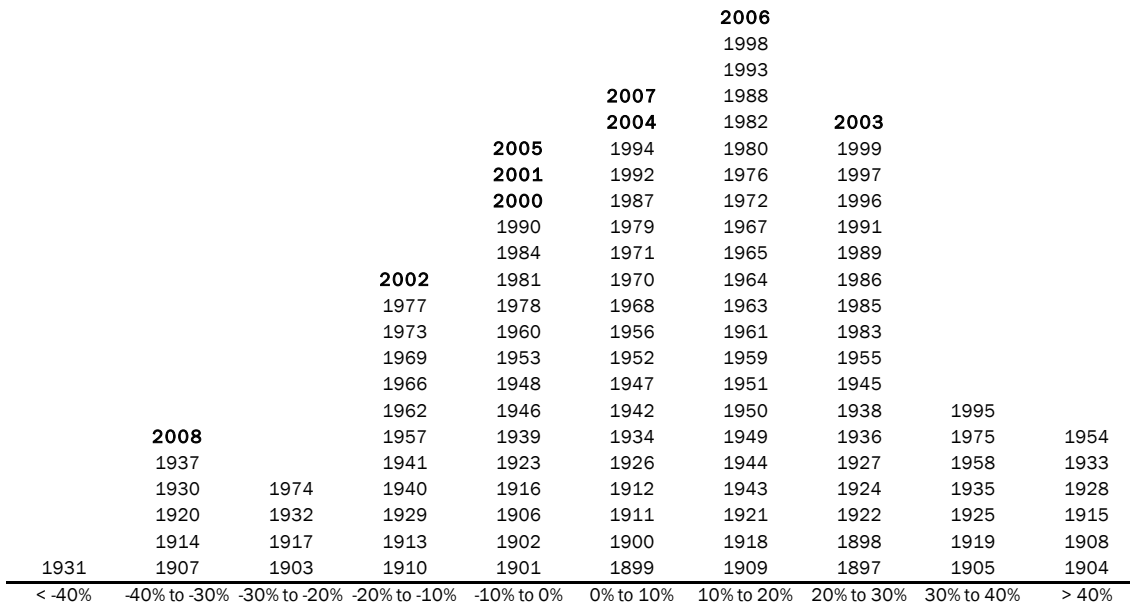
Similar to past negative market periods, diversification among equity styles and capitalization ranges offered little protection. Within the domestic large cap space, the two largest sectors (information technology and financials) were down 35% and 25% during the fourth quarter.

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.

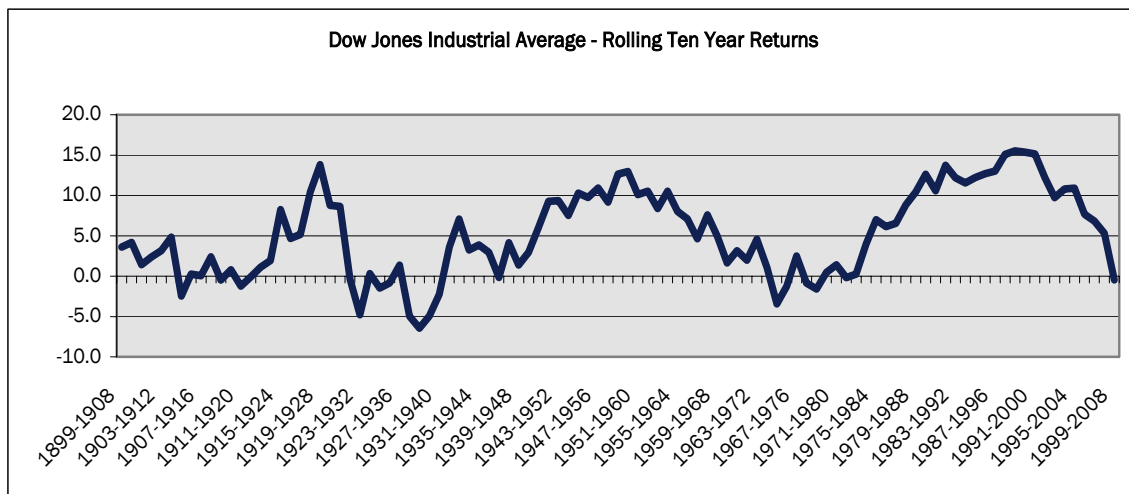
If it were not for the -31.7% return in the materials sector, IT and financials would have been the worst two performing sectors. The selloff across all global regions, sectors, and capitalization ranges indicates that investors simply wanted to move out of equities. The strong fourth quarter bond returns tell us that investors sought the safety of bonds. However, with ten-year Treasury yields now 2.3%, investors did not choose bonds for their return potential. Clearly, this was a “loss avoidance” strategy.

By several measures, the financial markets of 2008 were historically some of the worst we have ever experienced. The Dow Jones Industrial Average lost 34% during the year, the third worst annual return since the 1896 creation of the DJIA.

Annual Returns of the Dow Jones Industrial Average



Even when you look at returns over ten-year time periods, we are flirting with historical lows.



The trailing ten-year return on the DJIA has dropped below zero for the first time since the 1970s. The only other times that trailing ten year returns have been this weak were in the Great Depression and World War I.

According to data compiled by J.P. Morgan Asset Management and Lipper as of November 30, there is \$3.7 trillion sitting in money market funds, an increase of almost \$550 billion from the beginning of the year. There is now more money in money market funds than is invested in all domestic equity mutual funds, which collectively are worth \$3.3 trillion. We believe that investors want to invest in equity funds, but simply have not regained the confidence to do so. However, we do not believe that investors will remain satisfied with the low interest being earned in money market funds for too long and will look to move towards equities as their confidence returns.

In the past decade, many researchers have conducted studies in investor confidence, a field known as behavioral finance. Behavioral finance is the study of how human behavior affects their investment choices. All investors like to think that they evaluate their investments rationally and objectively and never let emotion affect their decisions. Our experience has shown that most investors struggle to keep their emotions checked, especially when their portfolios are losing value. Investors may hold onto a losing stock or mutual fund too long because they do not want to realize a loss and admit a mistake. Often investors reach their “I can’t take it anymore” level at precisely the worst time – when an asset class is at its low. The associated problem surrounds investors who only develop an appetite for an investment strategy once it has become overvalued. We think of 401(k) participants being guilty of being whipsawed in this manner, but institutional investors are subject to emotional forces as well.

Today, investors are suffering from the “snake bite” effect. Their investments in the equity markets have “bitten” them, and now investors are being overly cautious, emphasizing safety and security, even if the odds of being bitten again may be low.

The good news is that all of these behavioral traits are temporary. It was only in 2002 when we last witnessed similar trends. By 2003 though, investor confidence came roaring back. The country had made it over a year without another terrorist attack and the accounting frauds of the previous years appeared to be behind us. With little warning, the U.S. equity market rose 15.4% in the second quarter, 2.6% in the third, and 12.2% in the fourth to end 2003 up 28.7%.

While it is impossible to know how long it will take for investor confidence to return, **it will return**. Eventually, enough time will pass that the financial struggles of 2008 will fade away from our memories, replaced by new headlines and topics. It has not even been a year since the failure of Bear Sterns, but it has already been made “old news” by more recent events. What is most encouraging about the 2003 *market recovery* was that the *economy* remained very weak through much of the year. Unemployment peaked in June of that year, the same quarter when the U.S. equity market gained 15.4%. We believe a similar market recovery awaits and it does not necessarily need a strong economy for it to start, just the return of investor confidence. That is good news, especially given how weak the economy appears to be.

The Economy

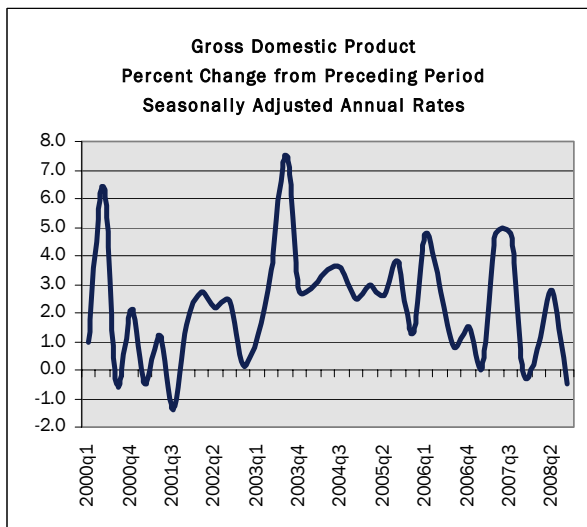
Much has been written about the economy in 2008 and most of it was negative. The economy dominated the news leading up to the November elections and it is fair to say that almost every American believes the economy is in bad shape. Let's begin 2009 on a positive note. Rather than spend the rest of this newsletter explaining how bad the economy is, I want to focus on historical recessions and what might be required to pull us out of this one.

Very few of our readers are economists and it might be helpful to review how our economy works. There are three major influencers in the economy, the consumer, the corporation, and the government. Each influencer both depends on and supports the others. If one influencer struggles, the others will likely struggle and if one influencer thrives, the others will likely thrive.

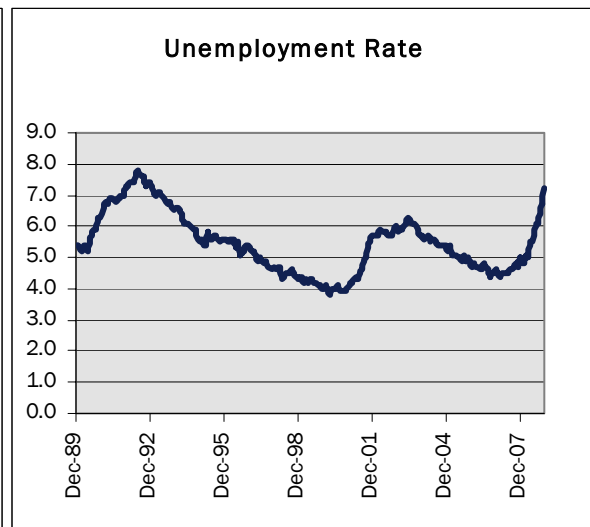
The consumer is the biggest part of the U.S. economy, representing about 70% of overall economic activity. Consumers purchase goods. Corporations provide the goods in exchange for the consumer's money. The corporation can then spend the consumer's money (the corporation's revenue) on salaries, raw material costs, new office equipment, advertising, and many other examples. Both the consumer and the corporation also pay taxes to the government. The government's role is to provide stabilization to the economy. Its main economic objective is to keep unemployment low and manage the nation's money supply. Too much money in the economy can lead to inflation, which leads to higher prices of goods, decreasing the amount of goods the consumer can purchase, slowing economic growth. Too little money can lead to a recession as consumers do not have enough money to purchase goods, no matter how cheap the goods might be.

Consumers currently find themselves very short of money. They are not purchasing as many goods and services as they have the past few years. Corporations therefore have less revenue and are decreasing their spending and laying off workers. The government will lose tax revenue, but it has the unique ability to borrow large amounts of money to continue its support of the economy. Although we are not normally proponents of government intervention, given the nature and scope of this particular downturn, the government may be able to expedite an economic recovery that might otherwise be more prolonged.

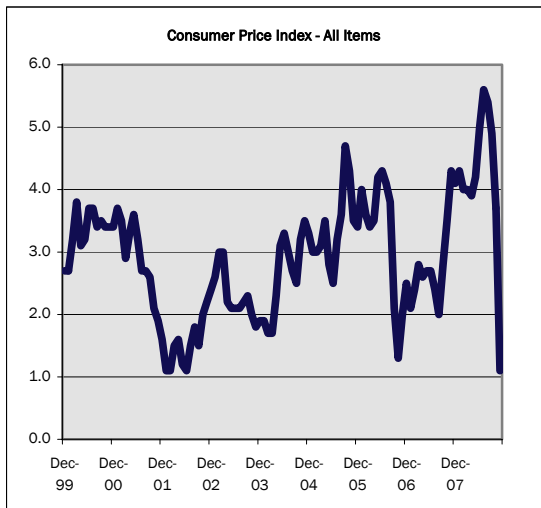
For those readers who enjoy statistics, here is where the economy stands as we enter 2009.



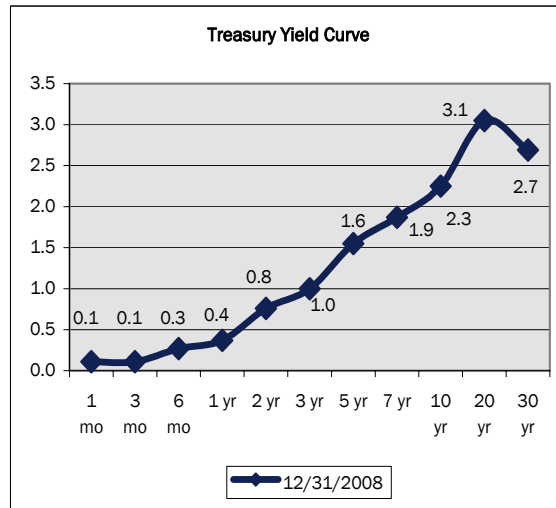
Source: Bureau of Economic Analysis



Source: Bureau of Labor Statistics



Source: Bureau of Labor Statistics



Source: U.S. Department of the Treasury

The economic troubles we are experiencing today are the most severe since the mid 1970's, which were the most severe since the Great Depression. In both of these eras, the government enacted new programs in an attempt to restore economic growth. While its programs were successful in helping certain key areas of the economy, collectively, the economy failed to fully recover. Some economic historians believe that government actions actually prevented recovery or extended the length of the economic troubles. As in these past times, the difficulty for today's government will be ensuring that it does not over regulate the economy and that any action it takes improves economic growth. It will be critical to balance its assistance for corporations versus its assistance for consumers.

During the Great Depression, the government sided with consumers over corporations. Programs were enacted to improve consumer wages and other benefits, much of it paid for by corporations. Many corporations, faced with declining revenues, could not afford to pay the new higher wages and benefits and many chose not to hire new workers. Unemployment remained high throughout the 1930s. The now infamous Smoot-Hawley tariff act was designed to help U.S. corporations increase revenues, but launched a global trading war that deprived U.S. corporations of the ability to sell goods overseas and U.S. consumers access to cheap imported goods. The lessons from the Great Depression are that unbalanced government intervention and an attempt to regulate trade can exacerbate or prolong a weak economy.

During the 1970s, the economy suffered from a variety of problems, most notably the scarcity of oil due to an oil embargo. Oil prices skyrocketed, leading to an increase in inflation and slowed the economy as the cost of producing goods rose. Rising inflation and slowing economic growth led to an economic situation known as stagflation. Ending stagflation proved to be very difficult. Restricting the amount of money in the economy will lower inflation, but will also lower economic growth. Increasing the amount of money in the economy will help it grow, but can cause a steep rise in inflation. The government's response in the 1970s was to flood the economy with money to boost economic activity. Inflation rose to over 12% per year, eventually requiring interest rates in the mid teens to control it. The economy did temporarily recover in the late 1970s, only the fall back again in the early 1980s under the pressure of high inflation.

What should President-elect Obama do to help today's economy? The road to economic recovery will require a sustainable increase in consumer's wages. It has become painfully evident that the past few years of economic growth was in some part created with borrowed money and not with wage increases. Consumers were willing to ignore the fact that their incomes had not grown as much as they would have liked because their investments were growing quickly, their houses were increasing in value, and low interest rates made it easy to finance every purchase. Wages must now begin to rise for consumers to grow their spending.

Increasing wages is much more difficult than it sounds. Raising the minimum wage or requiring companies to offer workers additional benefits are two ways to do this, but these put additional financial pressure on already struggling companies. Unless the government is willing to assist corporations with the additional costs, these ideas are doomed to fail, much as they did in the Great Depression. Tax cuts are another way to raise incomes, but they lower government revenues, which will likely be lower in 2009 already. Tax cuts could stimulate the economy by giving consumers more cash to spend, assuming they have the confidence to spend the cash.

The government is prepared to spend hundreds of billions of dollars (or more) to fix the economy. Unfortunately, the government does not have enough room in the budget to accommodate the new expenses. There are only two ways the government can increase their spending power – raise taxes or borrow the money. It is unthinkable that the government will raise taxes in the midst of a deep recession. The political fallout of doing so is more than most politicians could tolerate. In addition, given that our national income is falling and there are almost no capital gains left to tax, a tax increase will have less impact on the country's overall revenue than it would in a strong economic year. The government's more likely solution will be to borrow the money by issuing government bonds. Bonds provide cash that can be spent today, but must eventually be paid back with interest. Fortunately, interest rates are very low today, making the interest burden light, but almost all of the proposed new funds need to be borrowed. It is very likely that we will be paying off these bonds for several decades. Ideally, economic activity will increase, along with government tax revenues, which could be used to reduce the national debt. Realistically, we fear that higher tax rates will supply the revenue source.

We do not trust the government to efficiently spend large sums of money, but if they must, we support any program that can either provide long-term jobs or increase the wages of workers. The most discussed idea is a large public works program. Our country desperately needs new infrastructure - bridges, highways, railroads, power plants, new schools, fire and police stations. Infrastructure construction would employ many workers in the construction industry, many of whom were laid off in the past few months. The downside is that once these projects are completed, there will not likely be funding for additional projects and many of the newly hired workers will be laid off again. If the economy recovers and local, state, and the national government have higher revenues, construction projects could continue at their previous pace, saving these construction jobs.

The biggest challenge for the government will be to find ways to spend its resources without ruining the budget for decades. The money being spent is borrowed money, which will be paid back over the next several decades. Business leaders can tell you how unwise it is to use borrowed money to support everyday expenses. Therefore, any project the government supports must be both economically stimulative, and short in duration. Permanently

increasing the expense side of the budget is not the way to fix the economy. We think the best solution is a combination of a tax cut and large government spending on public works projects.

In Summary . . .

The financial markets took a great beating in 2008 and now it is the economy's turn. As in past recessions, we expect the market to begin its recovery much earlier than the economy. The government will need to play the leading role in our economic recovery, but it must learn from its past and spend its funds wisely. It must equally support both workers and corporations, or run the risk of stubborn high unemployment or labor strikes. It must not flood the economy with money simply because it can, or run the risk of much higher inflation. While the government may provide the first step, it remains up to the consumer and investors to determine when our economy and markets will recover.