

November 25, 2008

Re: An important message to our clients...

Dear Clients:

Last Thursday, November 20, 2008, the S&P 500 set a new low for the year, closing at a level last seen in December 1996. As has become painfully obvious, we are in the midst of an unprecedented period for the markets, where certain problems in our financial system that have never been experienced or dealt with before are causing severe problems in the broader economy, which has led to astonishing levels of stock market volatility on a daily basis.

Since the end of the Third Quarter, average daily volatility on the S&P 500 has been running at a level almost 4 times greater than its long-term average, implying that every day between 9:30am and 4:00pm, investors' estimate of the total long-term value of the stock market changes by more than \$300 billion. It seems fundamentally clear to us that the actual intrinsic value of publicly traded US companies is not changing by nearly that much each day.

So what's going on? We won't get into a detailed explanation of the ongoing financial crisis here, but in a nutshell: banks took advantage of historically low interest rates to issue mortgage loans based on relaxed lending standards; larger banks bought massive amounts of these mortgages using leverage (also propelled by low interest rates); real estate values that became inflated during the lending frenzy subsequently decreased by an amount not seen since the Great Depression; much of banks' capital reserves were wiped out when they wrote down the value of those mortgages; a severe lack of capital caused banks to stop lending; businesses were unable to obtain financing that is necessary for their normal operations; and thus the economy has been thrown into recession.

But even with all of the problems facing our financial system and economy today, it seems difficult to believe that US companies are truly worth about half of what they were a year ago. We think that what's really driving the market today can be summed up in one word: uncertainty.

An Uncertain Market

Based on numerous conversations with investment managers and economists whose opinions we highly respect, it appears to us that what the market is experiencing is the end of a 20+ year era of easing credit, an era which allowed companies to earn higher profits based on borrowed money. What needs to happen, and is now underway, is the system must wean itself off of its high debt levels (a process known as deleveraging). This is likely to take a number of years, and over that time profits are going to come down. On the other hand, the profits that are left will be of higher quality, and ultimately those higher quality profits should lead to higher stock market valuations and accelerating earnings growth.

With so many variables involved, the market hasn't yet figured out just how to price this outcome. It's going to take time, and in the meantime the market, which is notorious for its dislike of uncertainty, is behaving wildly. Add to this the effects of the federal government's waffling on how best to fight the crisis, along with massive forced selling from mutual funds and hedge funds (it's estimated that about 20-30% of hedge fund assets may be leaving the market over the next several months, as the nature of their compensation structure makes it more profitable for hedge fund managers to close their funds after they experience losses rather than to try to turn things around), and we can start to see why the market is as volatile as it is.

Dealing with the Uncertainty

While we do not discount the gravity of the problems facing our economy, as long-term investors we need to decide whether or not these problems will permanently damage your investments, and therefore whether or not we should advise you to depart from your investment plan. One of the reasons why this financial crisis seems so distressing compared to past crises is that the problems facing our financial system are largely unprecedented, which means that traditional analysis techniques are limited in their ability to help us evaluate the situation. However, we do feel that there are ways to create an objective assessment of the long-term outlook for the economy and the markets, and our assessment is that this crisis will ultimately be resolved. Therefore, a departure from your long-term strategy is probably not warranted. In looking at the current situation, there are a number of factors we consider that bring us to this conclusion:

The Government Response: Do we believe that governments around the world will respond adequately to bring about a resolution to the crisis? This is arguably the most difficult matter to judge, but it does seem that governments the world over are committed to combating the crisis with a coordinated effort. So far we have seen:

- Lower interest rates through easing monetary policy by the Federal Reserve and other central banks.
- Numerous additional liquidity facilities by the Fed, including broader lending through its discount window.
- The \$700 billion Troubled Asset Relief Program (TARP), which is designed to stabilize markets by providing capital injections to institutions that have been harmed by troubled financial assets.
- Fiscal stimulus through tax rebates, and a high likelihood of additional fiscal stimulus to come.
- In the UK, a program to inject capital directly into troubled financial institutions. This has shown some degree of success, as it brings confidence back to the financial system by signaling that the government is willing to prevent banks from failing. This has since been adopted by a number of other countries, including the US.
- In China, a \$600 billion fiscal stimulus program (amounting to between 6% and 7% of Chinese GDP) to support infrastructure projects and employment.

Perhaps more importantly, governments have shown that while they may not be sure exactly how to solve our current problems, they know what *not* to do. They have thus far avoided the tactics that are believed to have led to the Great Depression and Japan's "Lost Decade." The steps they have taken to restore confidence in the financial system and inject liquidity into frozen credit markets will take some time to work, but we believe that governments have shown that they will lend whatever they must to whomever they must in order to work through the crisis.

Market Valuation: Another factor we look at in assessing the markets is valuation, or alternatively, what are market prices telling us about future expectations for corporate earnings? As of the market's close last Friday, the Price-to-Earnings (P/E) ratio on the S&P 500 (based on earnings for the 12-months ended 9/30/08) was 12.26x, meaning that one dollar of annual earnings costs \$12.26. This is significantly cheaper than the average P/E ratio in the post-Depression era of 15.7x. At this price for the market (the 'P' in P/E), in order for the P/E ratio to reach its long-term average, corporate earnings (the 'E') would have to drop roughly 42% from where they were at the end of 2006 before the crisis began (to a level of earnings last seen in mid-2003). While we

believe it is reasonable to expect earnings to decrease, our opinion is that the government response, combined with the demonstrated resilience of the US economy and the health of businesses outside the Financial sector will keep earnings from dropping so precipitously.

Leading vs. Lagging Indicators: It has been widely discussed that there are various signposts or indicators that will show improvement as we near the end of this crisis. For example:

- The Treasury EuroDollar (TED) spread (the amount of interest that banks charge to each other for short-term loans above the US T-Bill rate) will need to approach its long-term average of about 0.5%. It peaked at 4.6% in October, and has since come down to about 2.1%, which is an encouraging sign.
- Short-term interest rates should increase, indicating that the threat of deflation is abating. This has not yet happened.
- Housing prices will need to stabilize, and sales of houses will need to increase to a rate that brings the inventory of unsold homes from its current level of just under 10 months closer to its long-term average of about 6 months. This has largely yet to take place, but supply of unsold homes has decreased from its peak of about 11 months.
- The pace of banks' deleveraging should slow, and the banking industry should see continued consolidation. This process is already underway.

At the same time, we should also be mindful that certain factors will likely continue to deteriorate even after the economy turns a corner. Such lagging indicators include:

- Rising unemployment.
- Falling consensus earnings estimates (history shows that analysts tend to correct their earnings estimates too late in the cycle).

All that said, it is very important to know that the stock market tends to lead the economy in recoveries; past downturns suggest that the stock market generally bottoms and begins to rally about 6 months before the economy hits bottom. Therefore, while we are keeping a close eye on the above indicators, we also firmly believe that by the time the recovery becomes evident, it will already have been priced into stocks.

The Economy in the Long Run: There seem to be 2 paths that the economy will likely follow in the near term: either credit markets will take a long time to respond to government intervention, causing heavier collateral damage to the broad economy and leading to a long and drawn-out, or "bathtub-shaped" recession; or credit markets will thaw more rapidly and we will experience a short (but likely deep) recession, otherwise referred to as a "V-shaped" recession.

In either case, the economy will eventually find itself back on a growth path. In describing the natural tendency of GDP growth, many economists like to refer to the "1 + 2 = 3 Rule." This rule basically says that real GDP tends to grow at more or less between 2% and 3% per year, with about 1% coming from population growth and about 2% coming from productivity growth. Since we do not see any interruption to either population growth or productivity growth, we are confident that economic growth will ultimately converge to its natural long-run growth rate.

What This Means for Your Portfolio

Given everything we know today about the financial system, the economy, and the markets, our assessment is that stocks are undervalued, most bonds are undervalued (with the notable exception of Treasuries), and over the long-term we should see better returns from both. The principles of fundamental valuation are not broken; we are just in a (hopefully brief) period in which the market chooses to ignore fundamentals. We take heart from our investment managers, who virtually without exception agree that the market is currently offering once-in-a-generation buying opportunities, and we are confident that over the long-term sticking with the investment plan that we've created together will help you reach your financial goals.

In the meantime, we are focusing on a few investment themes that we believe will help us capitalize on the dislocations in the market. Specifically, we have invested in Buffered Return Enhanced Structured Notes, which provide a downside buffer against stock market declines and enhanced upside participation in the global equity markets.

Within our equity allocations, we are emphasizing owning companies with high quality earnings and low amounts of leverage, believing that as we move through the deleveraging process the market will place a premium on companies that can generate strong cash flows from global sources without requiring large amounts of external financing.

We are also looking to take advantage of certain credit opportunities, such as are available in municipal bonds, high quality corporates, as well as high yield corporates. Going forward, we view the extreme lack of credit in the markets as an opportunity for those with the ability to lend to command extraordinarily favorable terms. Bonds are providing far more yield than would normally be required to compensate investors for their potential to default, and as conditions normalize the prices of these bonds should increase to reflect a more rational assessment of risk.

In summary, we understand that the volatile state of the markets has been difficult to bear- it's difficult for us too. But, we have every reason to believe that we will recover from the current turmoil. Therefore, we are focused on maintaining our disciplined approach, being creative in looking for opportunities to take advantage of extreme valuations, and continuously reevaluating the risks facing your portfolio. If you would like to speak with us in more detail about your portfolio or financial situation, please don't hesitate to call us at 610-865-2600. At this time of year, it's appropriate to express our thankfulness and gratitude for your continued trust and confidence, as we work together through these trying times. We wish you and your family a Happy Thanksgiving and a Happy Holiday Season ahead.

Regards,

Paul D. Emrick, CFP, CIMA
Managing Partner

The Molewski Financial Partners Investment Committee