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Market Commentary Q3 2008

Overview

This is a historical period for the markets. The global economy faces liquidity issues far worse than anything experienced in history. There seems to be no prevailing logic; market movements have been based more so on emotion than on fact. All asset classes other than treasuries have experienced significant losses over the past few weeks. Stock markets have reverted back to levels seen over a decade ago. Cash holdings as a percentage of overall market valuation have reached near record highs. Since the announcement of the $700 billion bailout to fund the Troubled Asset Relief Program (TARP) created by the Treasury losses in almost all asset classes have doubled year to date. Fear and panic in the financial system ignited a huge decline in the velocity of money (how quickly money turns over). Banks are unable to find funding, even through short-term securities, which has led to hoarding of as much cash as possible and the curbing of loans, even to high quality companies, clogging vital arteries in the credit markets. One explanation for this is the mark-to-market accounting system that causes financial institutions to value some of their illiquid positions far below their held-to-maturity value. If 100% of outstanding subprime mortgages were foreclosed on, these bonds would still be worth at least 40 cents on the dollar (Brian Wesbury, ftportfolios.com), but default rates are currently well below this level.

Central banks worldwide have taken aggressive and unprecedented steps in an attempt to improve liquidity and growth with no tangible results thus far. Markets ended lower on October 8th, despite a coordinated interest rate cut between central banks around the world. While current economic fundamentals are worse off than they were a year ago, market prices reflect even further negative sentiment over the next 6 to 12 months. Unemployment remained consistent through September at 6.1%, but is expected to climb as high as 6.8% by the second quarter of 2009. CPI for August was 5.4% year-over-year, but is expected to drop to 1.9% by the third quarter of 2009 (Core CPI, excluding food and energy, was 2.5% for August). GDP, which came in at 2.8% for the second quarter, is expected to produce three consecutive quarters with flat to negative GDP growth (Bloomberg News monthly survey from Oct. 3rd 2008 to Oct. 8th 2008). It is generally accepted that equity markets tend to look forward roughly two quarters ahead of the economy. There are many reasons to believe we are at or are approaching a bottom, and we expect the next few months to bring the beginnings of stabilization in the global economy and the reintroduction of liquidity to the short and long-term credit markets. Historically, decisive government action has significantly reduced a banking crisis' effects on the economy. In the 1990s, for example, Sweden quickly recapitalized its banks in a similar crisis and its economy reaped the benefits with a strong, swift recovery. When comparable problems arose in Japan, its government was too slow to react, causing the country's economic woes to last for nearly a decade. The attention shown to the current economic crisis by our government and their willingness to intervene further than any other economic crisis in history is an optimistic sign.

Domestic

Inflation fears have receded as the price of commodities have substantially dropped. The moderation of inflation will help to restore the purchasing power of the consumer (the consumers' ability to purchase goods and services). Through midyear, continued consumer spending and growth in exports helped support our economy despite a severe housing recession and credit crunch. Since the summer, however, there have been signs that some economic fundamentals are deteriorating such as increased unemployment and a substantial decline in manufacturing levels. Although not everyone agrees with the recent actions taken by the FED, (expanding monetary and fiscal policy, and greater regulation) they will likely help foster financial stability which will lead to increased confidence among the financial institutions, reaccelerate lending which will ultimately spur economic growth.

Developed & Emerging Foreign Markets

Midway through 2008 international developed and emerging markets were on par with domestic equities, all down approximately 10-12% for the year. This was a very positive sign as these asset classes tend to outperform their domestic counterparts in bull markets. Things began to change in the third quarter where the S&P 500 returned -8.37% while international developed and emerging market equities returned -20.56% and -26.95% respectively. The third quarter is when the credit crisis truly became a global issue. Historically, we have come to expect underperformance in these asset classes during bear markets, but many economists believed these economies to be decoupled from our own and insulated from a US credit crisis. While developed and emerging foreign economies may be much more capable of sustaining decreased export growth than in the past, it is clear that they are still as dependent on capital and liquidity as ever. These markets have traditionally rebounded much stronger than domestic equities when market cycles turn from bear to bull.

Real Estate

U.S. home owners have seen a massive correction in home prices over the last year with nearly one in six homeowners owing more for a mortgage then the current value of their home. Our exposure to real estate, however, is through the commercial space; regional malls, industrial/office space, residential apartments, shopping centers and healthcare which has not been as severely impacted as the residential market. Year to date, our real estate funds, which were the worst performing asset class in 2007 are outperforming the overall market. Commercial real estate, however, is not immune to the issues related to the credit and housing problems and therefore, will slow as the rest of the economy suffers. For instance, office space vacancy rates have been growing at the fastest pace since 9/11 as bankruptcies and layoffs have been on the rise. Historically, this asset class has been extremely profitable and we continue to hold a small allocation in domestic REITs due to their attractive yields and low correlation to stock and bond markets.

Alternative Investments

Natural Resources **-** When the credit crisis erupted in the US, natural resources prices were pushed higher due to strong growth in the emerging markets, a weakening US dollar (partially caused by numerous interest rate cuts), and speculative demand by investors. In recent months, however, escalating fears of a global economic recession coupled with a strengthening US dollar has resulted in a massive pullback in the price of natural resources. Prices may continue to fall in the near future, but it is important to note that we still believe natural resources are in the midst of a secular bull market. The demand for raw materials and energy will not go away and as the economy begins to recover, energy demand will be restored and prices will move upward once again.

Managed Futures **-** The Rydex Managed Futures fund has added stability during the most volatile time in market history. For the month of September this fund outperformed the S&P 500 (total return) by 11.74%. The fund did not perform within expectations just after its inclusion to LAMP in July. Its initial dip was caused by a significant shift in momentum within commodities markets. Since then it has acted as a buoy for our portfolios over the past couple weeks. This fund is built to follow trends and is weakest when trends shift quickly and significantly. New trends have formed in the commodities and currencies markets and Rydex has done a very good job of taking advantage of these newly formed trends.

Fixed Income
Our domestic high quality and liquid fixed income positions have benefited from the widespread flight to quality and have helped to reduce the volatility of our portfolios. The 10-Year Treasury note was among the world's top performing assets during the past three months. We have always had a diversified exposure to fixed income securities holding treasuries, corporates and municipal bonds. While corporate bonds have underperformed treasury bonds year to date, as we begin to see an economic recovery, corporates should begin to outperform treasuries. Year to date, our international bond positions have not yielded positive returns largely due to a rebound in the US dollar. However, the recent announcements by multiple central banks around the world including England, China, Canada, Sweden, Switzerland and South Korea, to begin lowering interest rates in an effort to ease the credit markets should positively impact the sector by making the existing higher yielding bonds more valuable.

Conclusion
Based on a wide variety of measures, investors are as bearish as they have ever been and history has shown that market bottoms occur when pessimism is at its highest. Although we cannot guarantee that the worst is behind us, it is likely that we are nearing a bottom. While we are certain that you are concerned about your investments, this is not the time to go to cash. Studies have shown that both amateurs and professionals alike usually ineffectively time the markets, and missing a few big days can have a dramatic effect on long-term portfolio returns. For example, a $100 investment in the Dow Jones Industrial Average at the beginning of 1990 grew to $453 by the end of 2006. However, if you missed the 10 best up days in the market that investment would only end up equaling $281. Furthermore, if you were unfortunate to miss the 100 best trading days that investment would have actually resulted in a loss of 72% of the initial invested capital (Estrada, 1/08). This clearly demonstrates that staying invested and not trying to time the market is a proven discipline. Fear is a powerful motivator but should not sway you from your long term investment plan. Patience is the key to successful investing.