

# Quarterly Commentary

## Market Overview

Recanting headlines thus far in 2008 would prove not only depressing, but seemingly endless in detail. Nonetheless, a few relatively simple thoughts can summarize the situation.

The US economy has been fueled by debt for many decades, but recently saw a spike in debt and leverage at the household and corporate level. When the Federal Reserve rapidly increased short term interest rates a while ago, it served to shock a highly levered financial system that was already coping with rising energy and natural resource prices. The end result was faltering short term mortgages and a burgeoning crisis amongst financial institutions with leveraged bets on mortgage backed assets. These impending losses broke the market's collective will to lend and were the beginning of a downward spiral in credit conditions. Though the Federal Reserve made every effort to improve the situation, the quantity of dollars involved was simply too vast to stem the tide. A cycle of de-levering and loss realization began that cascaded throughout the economy and financial markets, resulting in investment losses and multiple corporate failures.

As investors recognized the relatively unprecedented and serious nature of these events, capital markets around the world discounted the value of anything that contained risk. This is why the only instruments that have not lost money so far in 2008 were cash, treasuries, and mortgage bonds backed by the US government. Fear and panic ruled the day.

To boot, the US Government was forced to take a substantial, direct economic interest in mortgage-backed bonds and several financial corporations in an effort to preclude financial meltdown. The scope of these open market actions only served to reaffirm the potentially dire status of the global economy. When was the last time the President of the United States felt it necessary to assure you your checking account was safe?

## Macroeconomic Implications

Without a doubt, the most important aspect of recent events is the government's newfound debt and equity holdings, and continued need to provide liquidity to financial markets. Like it or not, the US economy is addicted to leverage and the political will to go "cold turkey" simply isn't there. The ultimate solution to our problems, though controversial as it may be, is inflation. To understand this rationale, let's quickly review the problems facing our economy.

First and foremost, credit markets have tightened. The obvious answer to this problem is continued lending from the world's central banks to compensate for broad de-levering amongst financial institutions. The Federal Reserve is pouring hundreds of billions into markets and central banks around the world are cutting rates. On top of this, the Federal Reserve is now buying not only mortgage bonds, but commercial paper as well. These actions are monetary stimulus and open market actions right out of a macroeconomics 101 textbook. Both are inflationary in nature.



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Secondly, US household balance sheets are in shambles. For decades Americans have spent more than they earn, systematically eroded their home equity, and let their cash holdings dwindle. Furthermore, globalization is steadily eating away at growth in real US wages. So it appears the income and asset side of the balance sheet is deteriorating. Because the government cannot tell people how to spend their money or stop economic globalization, its only means to address this problem is by affecting the liability side of the equation. The answer again is inflation because it will erode real value of societal debt and therefore repair balance sheets. This essentially amounts to a transference of wealth from lenders to the borrowers slowly over time. Given foreign investors hold so much of our debt, this does not seem such a bad idea.

Finally and probably most importantly, real estate has become the new “gold standard” in a manner of speaking, meaning real estate values and growth thereof have been the basis for vast amounts of consumer lending vis-à-vis home equity withdrawals. In order to support growth in consumer spending and stabilize credit markets based on real estate, prices must go higher. Also when you consider the government’s newfound \$350-\$700 billion investment in mortgage backed bonds, the motivation to increase housing values is undeniable. Again, inflation would serve us well in this regard through price appreciation.

## [Some Encouragement](#)

Encouragingly though, the fact of the matter is that as long as people keep working every day to produce goods and services, the economy will grow. Let’s not be fooled by the mainstream media. We are not dealing with another “great depression.” Our unemployment rate is only about 6%, the government is doing everything it can to keep cash flowing, and the world is so economically intertwined the US economy cannot be allowed to succumb to catastrophe. Our problem is one of numbers and finance, not one of mass unemployment and a dearth of goods and services.

So the question is not whether our economy will continue to function, but how it will continue to function and how wealth will be distributed as a result. Inflation seems inevitable in our minds. So we must therefore advise our clients to invest heavily in assets that protect against inflation.

## [Strategic Asset Class Implications](#)

Moving downward in our view of the world, we believe there are many worthwhile strategic opportunities to consider as a result of recent market volatility.

Equity markets worldwide have taken the brunt of investors’ aversion to risk. They are far more attractively priced than just nine months ago, with the most favorable valuations being held by international equities. If you examine historic equity returns relative to various fundamental factors, you will find the sum of



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equity earnings and dividend yields offer high predictive value. As of September, international equities were priced to provide 12-13% returns over the next ten years, well in excess of the 7-8% projected for domestic equities. Keep in mind these expectations are based in local currency terms (or on a hedged basis). So this return differential could be substantially eroded by US dollar appreciation, making currency hedging an important consideration. It is an interesting idea to think global equity markets are implicitly priced in US dollars, which could explain this vast difference in valuations.

Within domestic equity markets we are seeing slightly expensive valuations for small cap equities in relation to their large counterparts. US large growth stocks appear attractive relative to value stocks, but the same is not true in the small cap universe. Internationally, we have seen the premium in valuations for emerging markets eroded relative to developed markets. Nonetheless, emerging market equities remain valued at parity with developed markets and warrant some caution as a result.

Fixed income markets also offer compelling opportunities as a result of the flight to quality over the past year. US Treasuries could very well be priced to provide an almost zero real rate of return over the next decade. Agency mortgage-backed bonds offer a healthy premium over Treasuries, especially considering their newfound government backing. Going up the spectrum of risk, corporate debt yields spiked during the last quarter and are now yielding about double US Treasuries. High yield debt has become far more attractive as well with yields 4-5 times that of

Treasuries. Most interesting though, is the current pricing of inflation protected bonds (TIPS). This is because the implied rates of inflation have rarely been experienced historically, let alone in this potentially inflationary environment. In terms of risk free fixed income, TIPS appear to trounce nominal Treasuries in expected returns.

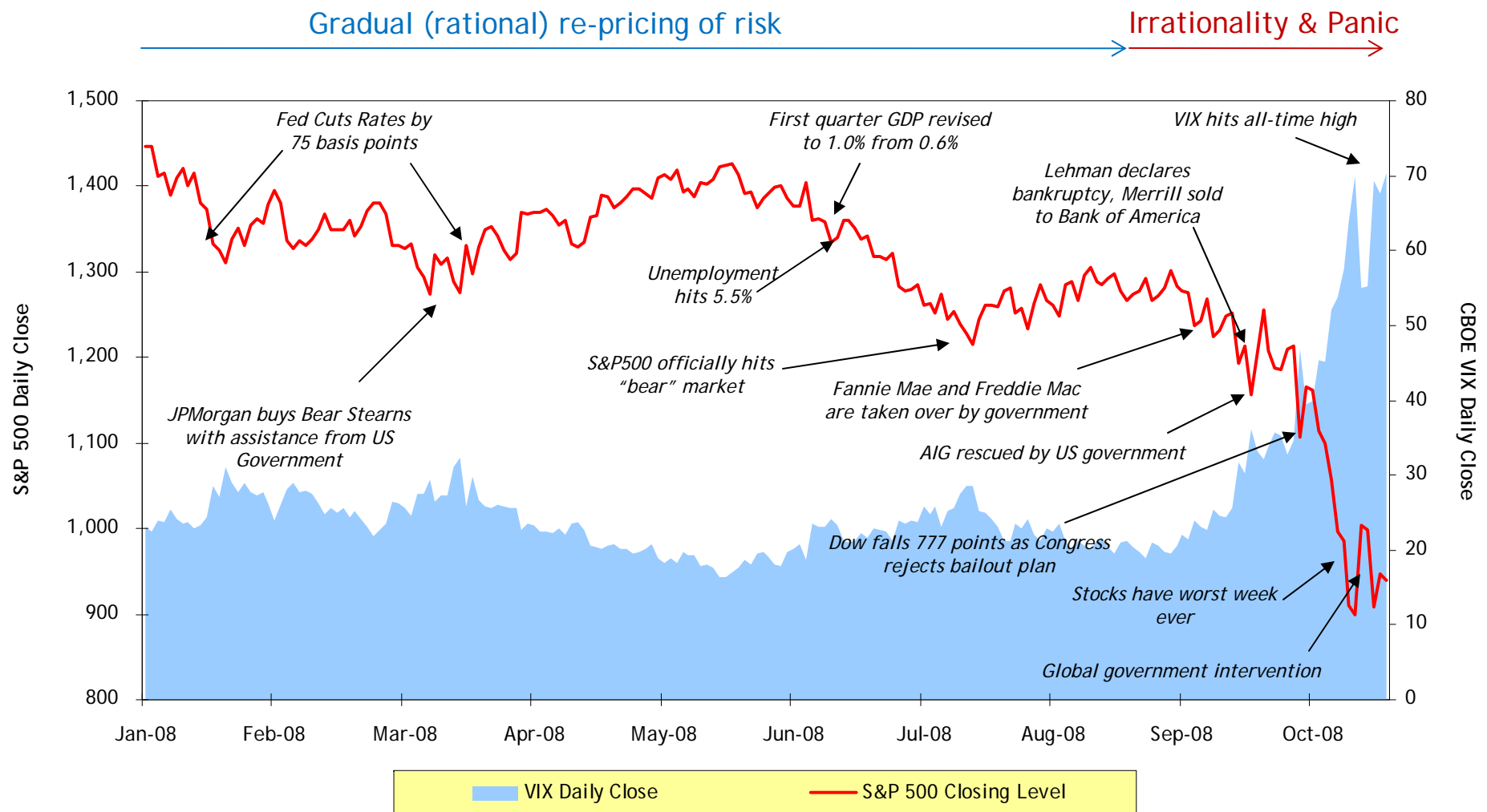
Within the universe of alternatives, we firmly believe distressed debt strategies are very attractive. Tighter credit markets and economic weakness will almost certainly create ample opportunities in corporate, mortgage, and commercial real estate fixed income markets. Commercial real estate prices appear to be holding somewhat steady, but on a low volume of transactions. However, income is the primary component of returns in these investments and capitalization rates indicate reasonable income going forward. Hedge funds may be in store for their first real crisis as credit markets have tightened, leaving highly levered strategies with an anchor to performance. Going forward we would expect arbitrage and absolute return strategies to suffer relative to their historic returns, and more directionally-biased, lower leverage strategies to do better going forward.

## Concluding Thoughts

To conclude, one should step back from the short term chaos of market activity and focus on a long term macro perspective. With the right state of mind, the writing on the wall will come into view.



# 2008 Year-to-Date Market Activity

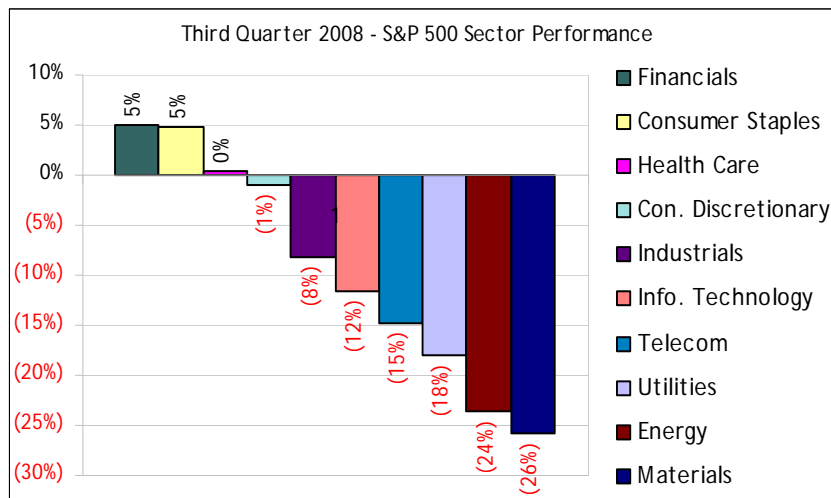


As of October 17, 2008. Source: Chicago Board Options Exchange, Yahoo Finance. The CBOE Volatility Index (VIX) is a key measure of market expectations of near-term volatility conveyed by S&P 500 stock index option prices.



# Domestic Equities - September 2008

- With the exception of small value stocks, all equities lost ground during the quarter.
- Year to date double digit losses are the norm across all styles and capitalization ranges.
- Interestingly though, financials were the best performing sector over the last quarter, but remain almost the worse year to date.
- Growth lagged value during the quarter and year to date.

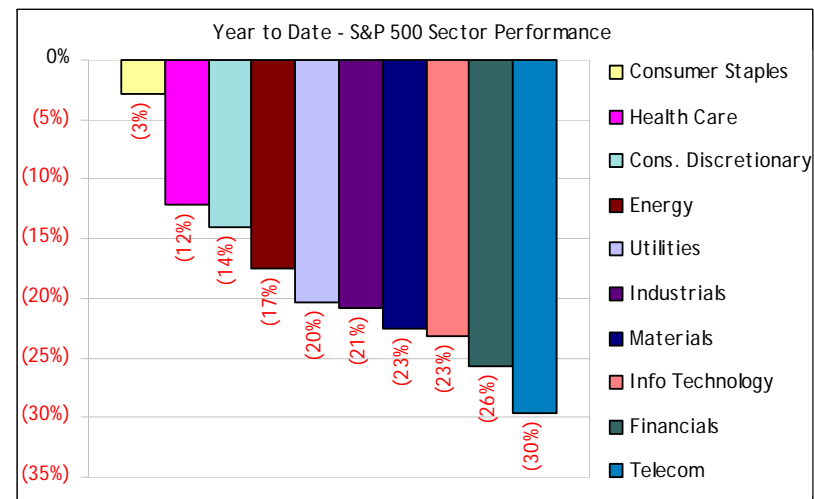


Source: ICC



	Quarter	YTD	One Year	Last 3 Years	Last 5 Years	Last 10 Years
<i>Core Index Performance</i>						
S&P 500	(8.4)	(19.3)	(22.0)	0.2	5.2	3.1
S&P 500 Equal Weighted	(7.9)	(17.9)	(22.0)	(0.4)	7.0	7.3
DJ Industrial Average	(3.7)	(16.6)	(19.9)	3.3	5.6	5.5
Russell Top 200	(7.9)	(19.5)	(22.0)	0.2	4.3	1.9
Russell 1000	(9.4)	(19.5)	(22.1)	0.1	5.5	3.5
Russell 2000	(1.1)	(10.4)	(14.5)	1.8	8.2	7.8
Russell 3000	(8.7)	(18.8)	(21.5)	0.3	5.7	3.8
Russell Mid Cap	(12.9)	(19.5)	(22.4)	0.1	8.6	8.3
<i>Style Index Performance</i>						
Russell 1000 Growth	(12.3)	(20.3)	(20.9)	0.1	3.7	0.6
Russell 1000 Value	(6.1)	(18.9)	(23.6)	0.1	7.1	5.6
Russell 2000 Growth	(7.0)	(15.3)	(17.1)	1.5	6.6	4.7
Russell 2000 Value	5.0	(5.4)	(12.3)	2.0	9.5	10.1

Source: Ibbotson

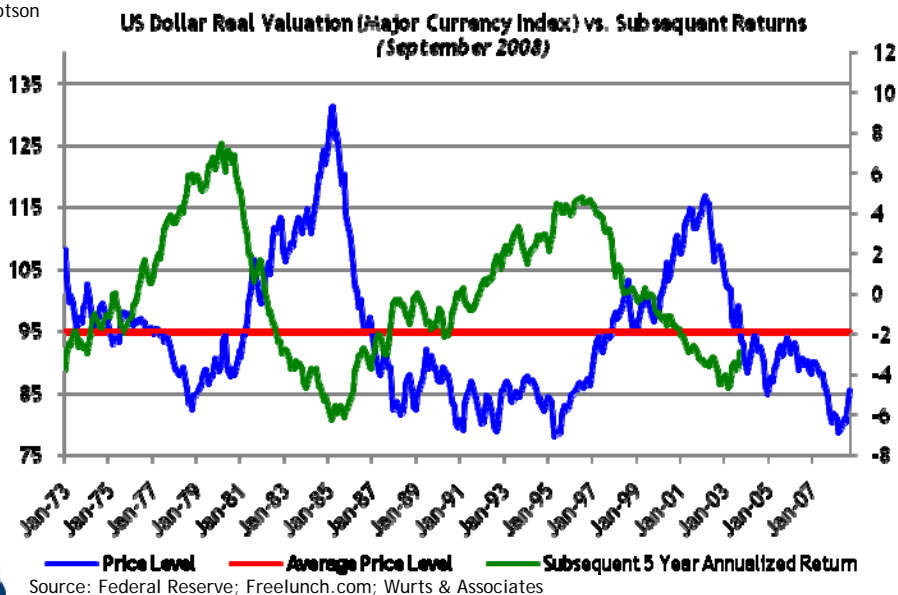
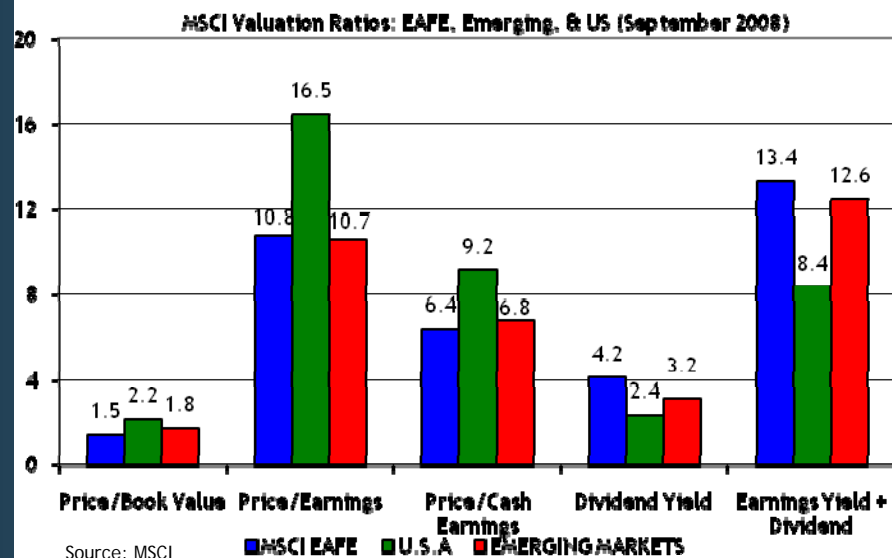


# International Equities - September 2008

- With an appreciation in the US dollar during the quarter, international equities posted more substantial losses than domestic stocks.
- The US Dollar remains undervalued relative to historic averages.
- On a global basis, international equities appear more attractive than US stocks.

	Quarter	YTD	One Year	Last 3 Years	Last 5 Years	Last 10 Years
<i>Broad Index Performance</i>						
MSCI EAFE	(20.5)	(28.9)	(30.1)	1.6	10.2	5.4
MSCI AC World	(16.5)	(25.2)	(26.5)	1.8	8.5	4.8
MSCI Emerging Mkts	(26.9)	(35.4)	(33.0)	8.7	19.1	14.8
MSCI EAFE Small Cap	(23.9)	(31.7)	(35.0)	(3.5)	9.6	NA
<i>Style Index Performance</i>						
MSCI EAFE Growth	(21.9)	(28.0)	(28.2)	2.5	9.6	3.3
MSCI EAFE Value	(19.1)	(29.8)	(32.1)	0.6	10.6	7.4
<i>Regional Index Performance</i>						
MSCI United Kingdom	(21.8)	(32.2)	(34.2)	(3.6)	4.8	NA
MSCI Japan	(17.5)	(26.0)	(32.5)	(6.0)	3.6	1.4
MSCI AC Asia	(20.8)	(31.8)	(33.9)	(2.3)	5.5	4.7
MSCI EM Latin America	(32.6)	(26.2)	(21.1)	18.2	32.9	20.4

Source: Ibbotson

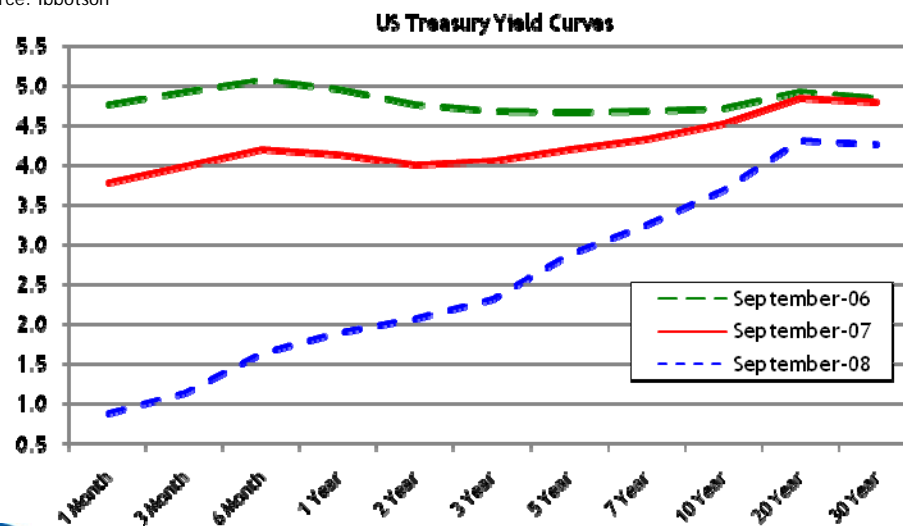
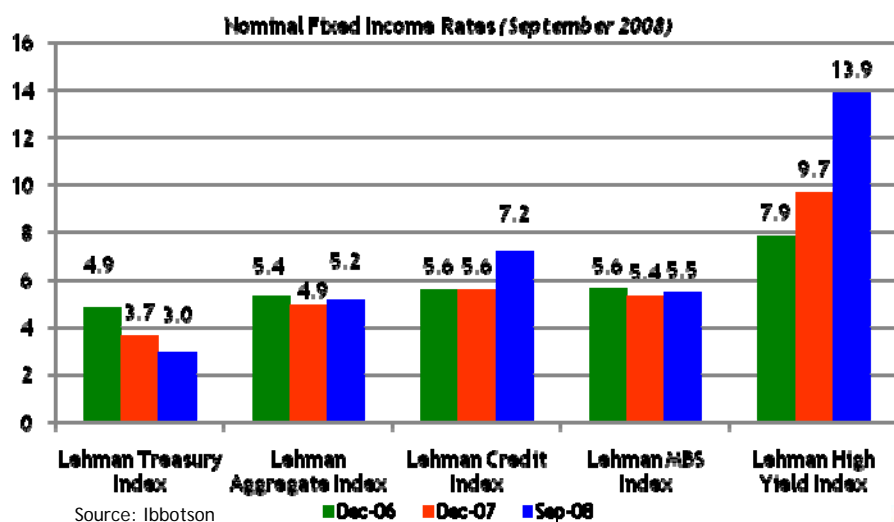


# Fixed Income - September 2008

- Fixed income markets had mixed results over recent periods.
- Investors continued to shy away from credit risk as evidence by losses in corporate, high yield, and emerging market debt.
- The yield curve has steepened tremendously over the last year.
- US Treasuries are priced to provide low yields as investors flocked to safety over recent periods.

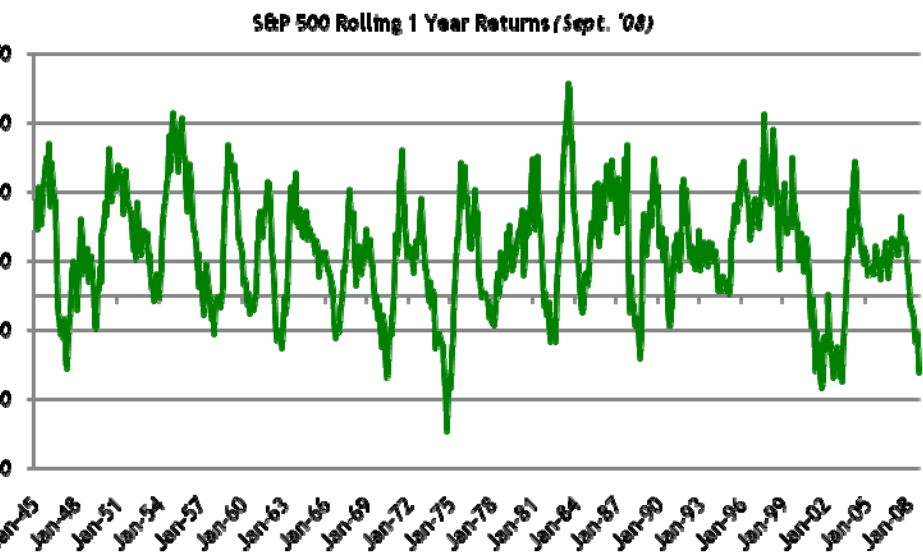
	Quarter	YTD	One Year	Last 3 Years	Last 5 Years	Last 10 Years
<i>Index Performance</i>						
LB US Aggregate Bond	(0.5)	0.6	3.7	4.2	3.8	5.2
LB US Treasury US TIPS	(3.5)	1.2	6.2	4.3	5.2	7.1
LB US Treasury Bills	0.7	1.9	3.0	4.2	3.3	3.5
<i>Maturity Evaluation</i>						
LB US Treasury 1-3 Yr	1.7	3.8	6.3	5.3	3.5	4.5
LB US Treasury Intermediate	2.2	4.6	8.3	5.9	4.0	5.0
LB US Treasury Long	2.8	4.5	10.4	5.7	5.8	6.2
<i>Issuer Performance</i>						
LB US Agcy Intermediate	1.1	2.9	6.0	5.2	3.9	5.3
LB US Credit	(6.4)	(6.8)	(4.8)	0.9	1.9	4.5
LB US Mortgage	1.9	3.8	7.0	5.5	4.8	5.7
LB US Corporate High Yield	(8.9)	(10.1)	(11.2)	1.0	4.4	4.4
LB Emerging Markets	(5.8)	(6.0)	(4.1)	3.7	7.5	11.9

Source: Ibbotson



# History of Bear Markets

Bear Market	Total Months	Total Decline (S&P 500 Index)	First Year After Decline (Total Return)	Second Year After Decline (Total Return)
Nov 1948 to May 1949	7	-10.0%	42.4%	23.8%
Jan 1953 to Aug 1953	8	-8.7%	35.0%	51.2%
Aug 1957 to Dec 1957	5	-15.0%	43.4%	12.0%
Jan 1960 to Oct 1960	10	-8.4%	32.6%	-14.9%
Jan 1962 to Jun 1962	6	-22.3%	31.2%	21.5%
Feb 1966 to Sep 1966	8	-15.6%	30.6%	9.6%
Dec 1968 to Jun 1970	19	-29.3%	41.8%	10.7%
Jan 1973 to Sep 1974	21	-42.6%	38.1%	30.5%
Jan 1977 to Feb 1978	14	-14.3%	16.6%	24.5%
Dec 1980 to Jul 1982	20	-16.5%	59.3%	-2.9%
Sep 1987 to Nov 1987	3	-29.6%	23.3%	30.8%
Jun 1990 to Oct 1990	5	-14.8%	33.4%	9.9%
Jul 1998 to Aug 1998	2	-15.4%	39.8%	16.3%
Apr 2000 to Sep 2002	30	-43.8%	24.4%	13.9%
<b>Average</b>	<b>11.3</b>	<b>-20.5%</b>	<b>35.1%</b>	<b>16.9%</b>



Source: Ibbotson

Strong corrections are typically followed by strong recoveries.

**Nov 2007 to Sept 2008+ (?)**    11+ ?    -23.3%    N/A    N/A

Source: Ibbotson






# Periodic Table of Returns - September 2008

	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	YTD 2008
Best	29.5	35.9	17.5	51.2	29.1	32.9	8.1	38.3	23.1	35.2	38.7	43.1	22.8	14.0	10.3	48.5	22.3	18.9	26.9	15.8	2.0
	28.6	25.2	8.9	41.7	13.8	26.3	6.4	37.2	21.6	31.8	20.3	33.2	12.3	8.4	6.7	46.0	20.7	14.0	23.5	11.8	1.6
	23.2	20.2	7.9	41.2	12.3	23.8	4.2	31.0	21.4	30.5	16.2	27.3	11.6	7.3	1.7	38.6	16.5	7.5	22.2	11.6	0.6
	20.4	18.8	2.6	24.6	8.0	18.1	2.7	25.8	14.4	18.6	15.6	26.5	7.0	4.1	1.0	30.0	14.3	7.1	16.1	9.9	-5.4
	11.7	14.5	2.3	21.7	7.8	13.4	-0.8	24.6	14.1	16.2	13.6	13.0	6.0	2.8	-8.6	29.7	13.1	7.1	13.4	7.9	-11.0
	11.3	12.4	-0.3	16.0	7.4	11.5	-1.5	18.5	11.3	13.9	8.7	11.4	4.1	-2.7	-11.4	21.6	11.1	5.3	12.8	7.1	-13.8
	9.6	10.8	-8.1	14.5	5.0	9.8	-2.0	11.6	10.3	12.9	5.1	7.3	1.9	-5.6	-15.5	11.6	6.9	4.7	10.4	7.0	-15.3
	7.9	8.6	-17.4	12.5	3.6	3.1	-2.4	11.1	6.4	9.7	1.2	4.7	-14.0	-9.2	-15.7	9.0	6.3	4.1	9.1	4.7	-18.9
	6.8	7.8	-21.8	5.8	-4.3	2.9	-2.9	7.5	5.3	5.3	-5.1	-0.8	-22.4	-20.4	-27.9	4.1	4.3	3.0	4.8	-0.2	-20.3
Worst	N/A	N/A	-23.2	-5.6	-11.9	1.4	-3.5	5.8	3.6	2.1	-6.5	-1.5	-22.4	-21.2	-30.3	1.1	1.2	2.4	4.3	-9.8	-28.9


 Large Cap Growth US Stocks (Russell 1000 Growth Index)

 International Stocks (MSCI EAFE Index)

 Large Cap Value US Stocks (Russell 1000 Value Index)


 Domestic Fixed Income (Lehman Bro Aggregate Bond Index)


 Small Cap Growth US Stocks (Russell 2000 Growth Index)

 Real Estate (NCREIF Property Index)

 Small Cap Value US Stocks (Russell 2000 Value Index)

 Cash (Citigroup 3-Mo Treasury)

 Hedge Fund of Funds (HFRI Fund of Funds Index)

 ICC Universe Median (Total Funds)

Data: Ibbotson Associates, As of 9/30/2008; Independent Consultants Cooperative.



# Additional Research is Available

Wurts & Associates offers its clientele an in depth analysis and proactive view of economic and capital markets conditions.

Our [September 2008 Market Environment](#) can be found at [www.wurts.com/knowledge/](http://www.wurts.com/knowledge/), and discusses:

- Macroeconomic conditions for the United States with respect to credit markets, GDP, debt, inflation, etc.
- Global equity market valuations, including detailed analysis of domestic equity markets
- Opportunities in fixed income and credit markets
- Conditions in commercial real estate
- Distressed debt investing

Additionally, clients may access a recording of our [Quarterly Research Conference Call](#) that took place on October 17, 2008.

Playback

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