



Investment Overview

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Economic and Markets Summary

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Fourth Quarter 2008

The Economy

The economy weakened considerably during the fourth quarter of 2008. Third quarter real Gross Domestic Product dropped into negative territory, falling -0.5%, after the first two quarters of 2008 grew +0.9 and +2.8 respectively. Fourth quarter real GDP should show the economy declining at a -4.0% rate or more. The first estimate of fourth quarter GDP will be released January 29.

On December 1 the National Bureau of Economic Research (NBER) declared the U.S. economy to be officially in a recession. The NBER also said the economy has been in a downturn since December 2007, confirming what many Americans have felt through most of 2008.

Now the question becomes, "How long will the recession last and how deep will it be?" Many private forecasters have warned that this downturn is likely to be more painful and last longer than any recession since the one occurring in 1981-82. Many economists expect the recession to last at least into spring, which would make it a minimum of 17 months long. By contrast, the longest post-World War II recessions (1981-82 and 1973-75) each lasted 16 months.

Economic indicators during the fourth quarter were uniformly negative for both the industrial and consumer side of the economy. On the industrial side, factory orders, construction spending and industrial production all were very weak, confirming the huge drop in the ISM indicator of manufacturing and capital spending intentions. The consumer side was even worse as auto and housing sales were dismal, retail sales very weak and consumer confidence fell off a cliff. The key monthly employment report continued to deteriorate. The

unemployment rate released December 5 rose to 5.7%. The string of negative job creation monthly numbers continued as the year ended. The December 5 report showed job losses, which had already amounted to 1.2 million since the beginning of the year through November, amounting to an additional 533,000 jobs lost during the month.

The downbeat assessment of the economy was corroborated by the Federal Reserve's "beige book" survey. This roundup of anecdotal reports from the 12 regional Fed bank released early December showed economic softness continuing across all 12 of the Federal Reserve's districts. Districts reported decreases in retail sales including vehicle sales, and tourism spending was subdued. The housing market remains weak with lower selling prices. Furthermore, the report stated that commercial real estate activity generally declined in most districts and lending standards have tightened.

Even the optimistic forecasters are expecting the recession to last until mid-2009 at the earliest. It could be more severe as American consumers are re-trenching for the first time in almost 20 years or more. Since 1982 recessions have been short and shallow, as more debt was taken on to produce successively smaller increases in GDP.

Current prevailing economic problems have caused enormous wealth destruction at a time when household debt levels are at record highs, employment is falling, wage growth is weak and the personal savings rate is low. At the same time, the credit crunch has raised the cost and reduced the availability of credit. Although falling energy prices are providing some relief, there is overwhelming pressure on consumers to re-trench. Thrift, rather than debt-fueled consumption, will be the dominant theme for the foreseeable future.

The Economic recession is not confined to the U.S. but extends also on a worldwide basis. The chief economist for the Organization for Economic Cooperation and Development (OECD) said the global downturn will be the most severe in over a quarter of a century. The world recession will hit some countries harder than others. Those relatively worse off will be Hungary, Iceland, Ireland, Spain, Turkey and the U.K. as singled out by the OECD. China will continue above average growth but at a slower pace. China grew at a 11.9% rate in 2007, 9.4% in 2008 and is forecast to grow at a 7.5% pace in 2009.

Interest Rates

Some optimism exists for the economy to bottom out in mid-2009. In addition to a new major fiscal stimulus package after the new Obama administration comes into office, a historic amount of monetary stimulus is taking place. The Fed is flooding the financial system with liquidity in order to restore confidence in the banking system and credit markets. Continued lowering of Fed Funds is reaching an end, as Fed Funds get closer to zero. Consumers are being helped by the recent plunge in oil prices.

The Federal Open Market Committee (FOMC) of the Federal Reserve had two meetings on their schedule during the fourth quarter of 2008. However, before the first meeting took place at the end of October, and a week after the beginning of the quarter, the Federal Reserve felt a need to cut rates on an interim basis. In an emergency meeting on October 8 the Fed cut the Fed Funds rate by 50 basis points to 1.50%. Discount window rates were also cut by a similar amount and central bankers from Europe, Canada, and Australia also cut their rates in a coordinated effort. The following joint statement by the Central bankers was released at the time:

"The recent intensification of the financial crisis has augmented the downside risks to growth and thus has diminished further the upside risks to price stability. Some easing of global monetary conditions is therefore warranted."

The FOMC meeting of October 28-29 produced another lowering of rates. The Fed Funds rate was dropped another 50 basis points to 1.00%. In their post-meeting comments the FOMC stated, "The pace of economic growth appears to have slowed markedly. Financial markets turmoil will also reduce consumer spending in the months ahead. We expect inflation to moderate in the coming months and drop to Fed targets. Recent actions have improved credit conditions but downside risks to growth remain. The Fed will act as needed to promote sustainable growth and price stability."

The second meeting of the FOMC during the fourth quarter of 2008 occurred on December 16. In an unprecedented move, the Fed lowered rates to a range of 0-25 basis points instead of setting rates at a fixed level.

In their post-meeting comments the Fed stated that they slashed rates to historic lows to combat a deepening recession. Fed officials emphasized their commitment to "employ all available tools to promote the resumption of sustainable economic growth and to preserve price stability." They signaled the intention to keep Fed Funds "exceptionally low for some time." Also the Fed "will continue to consider ways of using its balance sheet to further support credit markets and economic activity."

In addition to the meetings of the FOMC and the adjustments to interest rates, the Federal Reserve and the Secretary of Treasury were kept quite busy in dealing with the credit crisis and the systemic risks in the near frozen financial system. Continued efforts and specific programs were unveiled to unclog the credit markets throughout the fourth quarter.

Two such programs were announced on November 25. One program provided up to \$500 billion for the government to purchase direct obligations of the GSE's to reduce cost and increase availability of credit for housing. This led to somewhat lower rates for mortgage borrowers. The other program was named the Term Asset Backed Loan Facility, or TALF. The objective was to provide \$200 billion to support the issuance of asset backed securities collateralized by credit card, auto loan and student loan debt. This type of financing came to a sudden halt earlier in 2008 as the credit crisis became more entrenched.

Other measures were also announced and terms and conditions on previously announced programs were altered, reflecting poorly on Secretary of the Treasury Henry Paulson. Secretary Paulson came under considerable criticism for some of these program changes which affected the bond market in a very negative manner. Some of the criticism was considered unjust, as government leaders tried to cope with an unprecedented crisis that had no "playbook" for knowing what to do. Conducting policy by "trial and error" inspired little confidence by bond market participants regarding finding solutions to the financial and credit crisis by Secretary Paulson and the rest of the outgoing administration.

This lack of confidence manifested itself in the bond market by an overwhelming desire to pile into U.S. Treasury securities no matter how minimal the yields. The safety and liquidity of U.S. Treasury debt was sought by investors worldwide who developed a mistrust of higher-yielding fixed income instruments as the year progressed and the crisis deepened. The decision by the government to oppose a bailout of Lehman Bros. sent them into bankruptcy. This had negative reverberations throughout the bond markets. Some money market funds held Lehman debt, which caused them to "break the buck" or go below \$1 per share. Many bond funds held longer-term debt of Lehman Bros. which affected their market values adversely, and again drove investors to the safety of U.S. Treasury securities.

This produced a very unusual bond market marked by ridiculously low yields approaching zero for U.S. Treasury Bills and very low yields for intermediate and long-term Treasuries. At the other end of the spectrum, higher quality corporate bonds were providing very generous yields to investors while corporations had to pay up to attract risk-averse buyers to achieve their longer-term financing goals. High yield, or junk, bonds were even more disadvantaged. Spreads continued to widen for lower-quality bonds to levels not seen for decades, as the prospects for worldwide recession highlighted the risks associated with this type of debt.

The movement of interest rates and the change in the yield curve can be seen in the table below, which shows various rates at the beginning of 2008 and the beginning and end of the fourth quarter.

	Treasury Bill		Treasury Notes & Bonds			FED Funds
	3 mo.	1 yr.	5 yr.	10 yr.	30 yr.	
12/31/07	3.24	3.25	3.44	4.03	4.45	4.25
9/30/08	0.88	1.77	2.98	3.83	4.32	2.00
12/31/08	0.11	0.34	1.56	2.25	2.68	0 - .25

The movement in interest rates created mixed returns for various bond fund categories during the fourth quarter and entire year. Below are some examples of different bond fund returns for 2008 according to the *Wall Street Journal*.

Year-to-Date Percentage Returns			
Global Corporate Bonds	-9.00	Investment Grade Corporate	-6.90
Long-term U.S. Gov't	+24.03	High Yield Taxable	-26.00
GNMA	+8.00	Municipal Bond Index	-2.47

Commodity prices were on a roller coaster in 2008 with rising prices through the first half of the year and rapidly descending prices in the last half. This was not only true for oil prices but for most other commodities also. The price of oil topped out during the second quarter around \$147 per barrel and plunged during the fourth quarter to end the year at \$44.60 per barrel. Oil began 2008 trading at \$95.98 per barrel and stood at \$101.00 at the end of the third quarter.

Gold traced a similar pattern as oil with a March 18 high of \$1,003.00 per ounce. However, gold showed less volatility throughout the year and held up better during the fourth quarter. Gold began the year at \$835.00 per ounce, traded at \$875.00 at the end of the third quarter, and finished 2008 at \$884.00 per ounce.

The Stock Market

The year 2008 will go down in history as one of the worst for stock investors. The stock market crash for the year just ended rivals the tremendous losses generated by stocks during the depression years of the 1930's. The drop in 2008 falls between the 33.8% loss for the

Dow Jones Industrials in 1930 and the 52.7% plunge in 1931. In addition to the uncertain outlook for the economy in 2009, forced selling by hedge funds, mutual funds, and leveraged stock buyers accounted for much of the constant selling pressure plaguing the stock market in 2008. In general, the overload of debt which had been building over many years has undergone massive de-leveraging, and stocks represent liquid assets that can provide funds in the de-leveraging process. Stock market investors sold across the board with little regard for value or future outlook.

The selling picked up speed during the second half of the year. After a drop of 8.90% for the S&P 500 in September, October lived up to its reputation as one of the worst months of any year for stocks by dropping 16.84%. There was no relief in November as the S&P declined another 7.10%. Thanks to year-end strength December ended up +1.05%. Perhaps the fourth quarter represented a selling climax and signals a better 2009 considering all the tax loss selling that occurred in December. On December 31, the Dow Jones Industrials closed at 8,776 and the S&P 500 ended 2008 at 903.25. For the year, the Dow Jones Industrials lost 33.84%.

The fund results table shows the major indices and the variability of losses for each category for the fourth quarter of 2008 and the calendar year. For a change international equities did worse than domestic. It was the worst year for foreign stocks since 1970. Emerging markets were worse off than developed markets dropping -54%. Growth and value both did poorly with a slight edge to value as far as relative performance was concerned. Smaller cap and large caps both performed miserably.

Defensive sectors outperformed within the equity market. Consumer staples, health care and utilities were the better performers on a relative basis. Financials need to be singled out as the worst performing sector in 2008 due to the bursting of the credit bubble and the subsequent write-offs and losses taken by various participants in the financial arena.

Regarding the domestic stock market, below is a chart of industry sectors ranked by percentage changes by Bloomberg Research at year end.

	Percentage Change by Stock Sector	
	4th qtr.	YTD
1. Consumer Staples	-13.54%	-17.66
2. Health Care	-12.72%	-24.48
3. Utilities	-11.95%	-31.55
4. Telecommunications	-2.86%	-33.61
5. Consumer Discretionary	-23.43%	-34.72
6. Energy	-21.05%	-35.93
7. Industrials	-24.66%	-41.52
8. Technology	-25.99%	-43.68
9. Basic Industry	-31.43%	-47.05
10. Financials	-37.64%	-56.95

The table below shows percentage returns for 2008, for various equity sectors and investment styles as computed by Lipper Inc., and featured in the *Wall Street Journal* on a daily basis.

Stock Fund Indices		As of 12/31/08
Large-Cap Growth	.....	-41.39%
Large-Cap Core	.....	-37.07%
Large-Cap Value	.....	-37.00%
Multi-Cap Growth	.....	-42.44%
Multi-Cap Core	.....	-39.45%
Multi-Cap Value	.....	-37.65%
Mid-Cap Growth	.....	-44.04%
Mid-Cap Core	.....	-38.53%
Mid-Cap Value	.....	-39.71%
Small-Cap Growth	.....	-42.62%
Small-Cap Core	.....	-35.39%
Small-Cap Value	.....	-32.82%
Equity Income Fund	.....	-35.40%
Science & Tech Fund	.....	-44.10%
International Fund	.....	-43.62%
Balanced Fund	.....	-26.18%

Despite falling corporate profits and operating earnings for the S&P 500 in 2009 plunging to a consensus of \$63.00 per share, there are a few rays of sunshine for stock market investors in 2009. Several factors could contribute an economic recovery beginning in the second half of the year, including a historic amount of monetary stimulus taking place, a major new fiscal stimulus package, and the tremendous drop in oil and gasoline prices which will help put money back into the wallets of consumers.

Richard Bernstein, a Merrill Lynch stock strategist who has had a bearish outlook for stocks through all of 2008, believes that better days could be ahead for stock investors. Their dividend discount model suggests double digit returns in 2009. Overall Bernstein believes "2009 will be a year of continued transition from the credit driven mania of 2000-07 to a more fundamentally based, conservative, and frankly more boring period." Stocks paying high and sustainable dividends should be a major stock market theme in 2009.

Fund Results | as of December 31, 2008

Equity Funds

	Quarter Return	12-Month Return
Allianz NFJ Large Cap Value	-25.30%	-40.57%
Allianz RCM Mid Cap	-26.56%	-41.74%
Fidelity Adv Eqy Income	-22.56%	-40.45%
Goldman Sachs Mid Cap Value	-23.71%	-36.47%
Janus Adv Intl Growth	-26.16%	-48.76%
JP Morgan Mkt Exp Idx Select	-25.97%	-35.45%
Lazard Emerging Markets	-30.50%	-47.88%
Stratus Growth Portfolio	-20.35%	-34.00%
Templeton Inst Foreign Equity	-20.16%	-42.15%
Thornburg Int'l Value	-19.35%	-41.65%
Vanguard 500 Index	-21.94%	-37.02%
Vanguard Morgan Growth	-24.40%	-41.33%
Vanguard Small Cap Index	-26.66%	-36.07%
Vanguard Strategic Equity	-27.21%	-41.61%
Idx: S & P 500	-21.94%	-37.00%
Idx: Russell 2000	-26.12%	-33.79%
Idx: EAFE	-19.92%	-43.09%
Idx: NASDAQ Composite	-24.37%	-39.98%

Fixed Income Funds

PIMCO Total Return	4.97%	4.82%
Stratus Gov't Secs	3.89%	6.17%
Templeton Global Bond	4.37%	6.47%
Vanguard GNMA	3.97%	7.22%
Vanguard Infl-Prot Secs	-3.89%	-2.85%
Vanguard Total Bond Idx	4.37%	5.05%
Idx: M.L. Int Term Bond	4.72%	9.33%

Past performance is no guarantee of future results.



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