A New Year?

Market Summary

December 2008

2008 was a brutal year for global capital markets. Equity markets were crushed and the global economy experienced its most severe financial crisis since the Great Depression. Financial institutions were battered by losses related to the collapse of the housing and credit bubbles. Governments and global central banks took unprecedented actions to counteract the credit crunch and stem the collapse of financial institutions.

Performance Summary

Index Returns	Dec.	4Q	2008
Wilshire 5000	1.7	-22.8	-37.2
S&P 500	1.1	-21.9	-37.0
Russell 1000 Growth	1.8	-22.8	-38.4
Russell 1000 Value	1.4	-22.2	-36.8
Russell 2000	5.8	-26.1	-33.8
Russell 2000 Growth	5.4	-27.4	-38.5
Russell 2000 Value	6.2	-24.9	-28.9
MSCI ACWI Index	3.6	-22.4	-42.2
MSCI ACWI ex-US Index	5.7	-22.3	-45.5
MSCI EAFE	6.0	-20.0	-43.4
S&P/Citigroup EMI-EPAC	7.7	-22.6	-46.6
MSCI Emerging Markets	7.8	-27.6	-53.3
Barclays Aggregate	3.7	4.6	5.2
Dow-Jones Wilshire REIT	17.7	-40.0	-39.2
DJ-AIG Commodity Index	-4.5	-30.0	-35.6

2008 was the worst calendar year for equity markets since the Great Depression. Domestically, the S&P 500 declined by 37% and the Dow-Jones Industrial index experienced its worst year since 1931. The peak-to-trough decline for the S&P 500 in this cycle is 52%, which makes this the third worst bear market in history. The S&P has recovered since hitting its November 20th low, but still finished the year 43% off its October 2007 peak (20% above the November 20 low).

Surprisingly, small-cap stocks outperformed large-caps in 2008 as the Russell 2000 index fell by 33.8%. Going forward, we expect large-caps to outperform small-caps. Large-cap stocks remain more attractively valued and should be better positioned to manage the economic downturn and the ongoing credit crunch.

Despite the collapse of the financial sector, there was little difference between the performance of large-cap value stocks and large-cap growth stocks. Small-cap value stocks were the best performing domestic style index. Small-cap financials held up relatively well on speculation that community banks and thrifts were not as exposed to risky securities as their larger counterparts and could benefit from the problems plaguing money center banks.

In addition to steep losses, investors also suffered through a constant wave of shocking news and large daily gyrations in the market. Volatility reached unimaginable levels during the fourth quarter. The VIX index, which measures the implied volatility in S&P 500 options, briefly topped 80. This implies average daily moves of 5%. During 2008, the S&P 500 moved more than two percent 72 times, or 28% of all trading days. The market experienced an astounding 17 five percent move days.

Even though this crisis originated in the US, foreign markets fared worse than domestic markets last year. The MSCI EAFE index lost 43.4% in US$ terms and 40.3% in local currency terms. In terms of regional performance, Europe lagged in both local currency terms and US$ terms, declining 38.9% and 46.4%, respectively. Japan benefited from a strong yen, losing just 29.2% in US$ terms, but fell 42.6% in local currency terms. Not surprisingly, emerging markets were the worst performing equity index, declining 53.3%. Emerging markets held up relatively well during the first half of the year, but collapsed as the global economy deteriorated and commodity prices plummeted.

The performance of the dollar was mixed in 2008. The broad trade-weighted dollar gained 8.6% last year as the dollar posted strong gains against emerging market currencies, the British pound, and the currencies of energy producing nations. The euro also declined by 4.0% against the dollar. The yen, however, appreciated strongly in 2008, rising by 18.9% against the dollar. The yen likely

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benefited from a reduced thirst of the carry trade as well as Japan's relatively limited exposure to the US subprime mortgage market.

Not surprisingly, the places where we have seen the greatest dislocations are in the credit and fixed income markets. As investors fled risky assets, Treasury yields plummeted. The yield on the 10-year Treasury fell from 4.04% at the start of the year to 2.21% at year-end. The sharp flight to quality pushed credit spreads to record highs. Forced selling by leveraged players in the credit markets also made matters worse as liquidity dried up and pushed spreads even higher. GSE-sponsored mortgage backed bonds are trading at an option-adjusted spread of 1.4%, even though these securities are now fully guaranteed by the US government. The option-adjusted spread on investment grade bonds rose to 4.93%, compared to a historical average of 1.25%. In terms of performance, Treasuries posted strong gains, rising 13.7%, while investment grade corporate bonds lost 3.1%, and high yield bonds declined 26.2%. While straight Treasuries posted strong gains, TIPS lost 2.4% as the inflation breakeven rate on 10-year TIPS declined from 2.3% at the start of the year to 0.12% at year-end. While deflation is a concern in the short-term, the fiscal and monetary policy actions taken to counteract the credit crisis and the recession are likely to trigger higher inflation in future periods. TIPS are offering cheap insurance to protect against this risk.

Commodities also experienced a turbulent year. Oil prices soared during the first six months of the year, hitting $145 a barrel in early July, but then tumbled by more than $100 by year-end and finished the year at $44 a barrel. The Dow-Jones AIG commodity index declined by just as much as stocks, falling 35.6%.

Future Outlook

2008 was an extremely painful year for investors and we estimate that the average endowment declined by around 28%. However, just because 2008 is now over, investors should not think that the problems of last year have been left behind. It is anyone's guess how markets will perform in 2009. Valuations on equities and credit instruments are compelling, but the market is going to be facing a deluge of bad economic and earnings news over the coming months. Things seem to have stabilized somewhat, but we remain in a very precarious situation. Investors should be prepared for volatility to remain at elevated levels in 2009. Markets are capable of tipping in vastly different directions: toward recovery or continued collapse. The recession, which started in December of 2007, is likely to be very deep and is likely to be the longest since the Great Depression. On the other hand, the Federal Reserve has committed itself to buying Treasuries and mortgage backed securities in order to keep mortgage rates low, and the government is likely to undertake a massive fiscal stimulus plan.

Instead of focusing on short-term news or making short-term predictions, we recommend that investors consider the long-term implications of the bear market. The upside of the current crisis is that equities are now trading below fair value and investors are being compensated for taking on risk.

Currently, the most attractive opportunities are in the credit space. Distressed debt funds should have plenty of opportunities, and investment grade corporate bonds offer attractive risk-adjusted returns. Equities are also attractive. Using our measure of normalized earnings, the S&P 500 is trading at a P/E of 14, which is its lowest level since the early 1990s. European equities are even more attractively valued trading at a normalized P/E of 11. Emerging markets, which were trading at a premium to developed market stocks at the start of the year, are once again trading at a discount to the rest of the world.

Although the times are uncertain, this very uncertainty can be rewarding for long-term investors because it has driven risk premiums to very attractive levels. In these times, the best advice we can give wavering investors is—remain at the helm, steady as she goes.

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