



INVESTMENT STRATEGY UPDATE

January 1, 2009

LOOKING FORWARD

The steepness and breadth of last year's economic and financial market setbacks were truly astounding. Nearly every asset class, many of which were once thought to be "low-risk," took a beating. As of the November low, U.S. stocks were down more than 50% from their peak and almost all of the foreign stock markets declined even more. Corporate bonds were sharply lower, as well, partly in sympathy with the related stocks and partly because normal credit market operations temporarily ceased to function. Large numbers of mortgage-backed securities traded at a small fraction of face value due to credit market concerns and declining real estate values, while lower property and sales tax revenues led to heightened concerns over municipal budget deficits and a drop in tax-free bond values. There was even one money market fund that "broke the buck." Only the lowest risk securities, U.S. Treasuries, moved higher.

The credit market chaos and subsequent meltdown of the financial markets were unlike anything the vast majority of investors, both professional and individual alike, had ever seen before. However, beaten and bruised though they may be, capitalism and the global free market system are still alive and functioning. Business is still conducted, stocks and bonds are still valued and transacted, and there are growing indications that the credit markets are beginning to loosen up. This is the time to absorb what we have learned from 2008, look forward, and structure investment portfolios for the months and years ahead.

The Economy

Clearly the U.S. economy is in tough shape. Consequently, the developed world economy, which started the year growing solidly, may actually contract for the first time since World War II. The questions on peoples' minds now are about how long the weakness will persist, and whether there is a risk that the recession we're in will turn into something worse.

Our view is that while the U.S. will experience a deep and somewhat prolonged recession, fears of depression are unfounded. There are supports in place, such as unemployment and FDIC insurance, which did not exist during the early 1930s. Furthermore, both our government and central bank are taking the necessary and appropriate steps to get credit flowing, provide liquidity to the economy, and hopefully create much needed new jobs as part of an infrastructure-oriented stimulus package.

This recession is unlike others we have experienced in the degree to which discretionary consumer spending has come to such a sudden halt, at all income levels. Given the tremendous loss of wealth in the global stock and real estate markets, and the rising unemployment rate, the justifiable attitude among consumers and businesses seems to be, "Let's hold back on spending until we can understand where things are and what is likely to develop." While such restraint is

a hallmark of any recession, it is also, unfortunately, part of a self-feeding spiral – constrained spending leads to lower corporate profits and additional layoffs, which portends even lower spending down the road. In the rapid onset of this consumer-led recession, that process has seemed magnified.

We are on the downward slope of a huge, unwinding credit bubble, the consequence of which is the current global recession. While the pain will gradually pass, we expect the effects to linger. One of the biggest lessons learned collectively in the U.S. and elsewhere is that there is a limit to the beneficial effects of leverage. We believe that the U.S. economy is in the midst of a long-term downward shift in the trend of consumption and, therefore, corporate earnings growth. Going forward, there will be an impact on how much debt consumers are willing to employ to fund their lifestyle. Over time, savings rates will increase, debt loads will decrease and, as a result, economic growth will be slower. We look for a gradually forming U-shaped economic bottom, with a slower resumption of growth than we've been conditioned to expect.

We anticipate that in coming months, as the new administration hits the ground running, consumer and business confidence will begin to return. Due in large part to the government intervening by lowering short-term interest rates to near-zero and buying commercial paper and mortgage-backed securities, the U.S. capital markets are already beginning to free up. In time, this will encourage financial institutions to lend, and the wheels of commerce will begin to turn more quickly. With that, investors will also begin to look forward to future earnings growth.

The Stock Market

The U.S. stock market, as measured by the S&P 500, declined 51.9% from its October 2007 peak to its November 20, 2008 low. That constitutes the worst bear market since the 1930s. Even more astonishing is the fact that the total ten-year stock market return as of November 20 was minus 23.6%, which equates to an average annualized loss of 2.7% over the last ten years. Put into historical perspective, calculated quarterly since 1926, only the ten-year returns ending in 1939 were worse, though not by much.

How is it possible that stocks have performed so poorly, particularly if one considers that corporate earnings have grown more than 5.5% annually over the past decade and dividend yields have been reasonably consistent? Since stock market returns can be roughly attributed to the sum of earnings growth, dividend yield, and changes in valuation, the answer must lie in declining valuations.

Think back to the technology bubble and the investor attitudes that existed some 10 years ago. It was the dawn of a new era, investors believed, and there was a massive collective desire to own a piece of it. In mid-1999, prior to the bust, the price/earnings ratio on the S&P 500 was an extraordinarily high 33, as measured on trailing twelve-month reported earnings. By mid-2007, before all the “mark to market” write-downs that wiped out financial company earnings, it was a more reasonable 17 times earnings. This compares to a long-term average ratio of closer to 15. Now, because of the stock market decline, there are numerous high-quality companies whose stocks are trading well down into low double-digit and even single-digit P/E ratios, on forecast 2008 earnings.

<u>Prior 10 Year ACR</u>				<u>Annual Compound Return</u>	<u>Total Return</u>	
-3.65%	Q2 1939	to	Q2 1949	8.62%	129%	
-2.79	Q1 1939	to	Q1 1949	9.12	139	
-2.74	Q3 1939	to	Q3 1949	7.74	111	
-2.54	Q1 1938	to	Q1 1948	11.76	204	
-1.42	Q1 1940	to	Q1 1950	9.65	151	
-1.42	Q2 1940	to	Q2 1950	12.19	216	
-0.65	Q4 1938	to	Q4 1948	7.21	101	← WORST
-0.10	Q3 1938	to	Q3 1948	8.12	118	
0.18	Q3 1940	to	Q3 1950	12.57	227	
0.20	Q4 1937	to	Q4 1947	9.61	150	
0.23	Q4 1939	to	Q4 1949	9.09	139	
0.44	Q2 1938	to	Q2 1948	9.52	148	
0.49	Q3 1974	to	Q3 1984	15.58	325	← BEST
0.71	Q1 1941	to	Q1 1951	14.47	286	
1.24	Q4 1974	to	Q4 1984	14.76	296	
			Average	10.67%	183%	

Source: The Leuthold Group

The Leuthold Group of Minneapolis, Minnesota, which has provided many of the statistics noted in this update, also put together the chart shown above. The chart displays the stock market returns which followed the fifteen worst ten-year periods. As shown, the subsequent ten-year annualized returns averaged a very favorable 10.7%. Even the worst of the subsequent periods provided a 7.2% average annual return. In other words, according to historical precedent, this should be a highly attractive time to invest in stocks.

So in our minds, the question is not whether to add to equities. Rather, it is when to do so. The time to have been bearish was a year ago. The stock market is a leading economic indicator, and typically a meaningful portion of post-recession bull markets has already occurred by the time investors recognize that a recession has ended. For now, we continue to proceed cautiously with regard to stocks, as we remain uncertain about the next few months. However, today's valuations are inexpensive, there is plentiful investor buying power on the sidelines earning very low returns, and from a lower base, earnings will start to grow again. BTR's investment focus is on high-quality companies, financial soundness, and our global themes for future growth, such as energy, infrastructure, agriculture, and the continuing emergence of China and the Asian tigers.

Fixed Income

We are selectively attracted to bonds. The extreme credit dislocations of the past few months have caused fixed-income yields, with the exception of U.S. Treasury debt, to rise significantly. And while the risks of default have also increased, we think the yields on many higher-quality corporate and municipal debt securities have risen disproportionately to those risks.

While high-quality corporate bonds have already risen sharply since the November lows, the debt markets are still quite stressed. As a result, current yields on such bonds are still quite a bit higher than before the credit crisis. We believe that the so-called blue chip corporations, as a group, are underleveraged and will almost certainly be able to make good on their obligations.

We also find the yields on high-quality municipal securities to be attractive, but, at the same time, we are very wary of lower-quality tax-free bonds. Although municipal bonds as a class have extremely low default rates historically, we could see that change during the current recession. With lower property and sales tax revenues, numerous municipalities are likely to have trouble meeting their obligations. Also, we place no reliance on the municipal bond insurers to strengthen those credits. Should circumstances get really difficult, we doubt those insurers will have the resources to fulfill their obligations. As such, we would only purchase municipal bonds with very high underlying credit ratings.

Lower-quality corporate debt issues (junk) may also be attractive, currently sporting 20%+ interest rates, but to be comfortable with junk bonds now, one would have to be both willing and able to put up with a rising level of defaults. We are not yet comfortable with the idea for client portfolios, but there may be a time to buy junk bonds during the first half of this year.

Finally, we are not attracted to U.S. Treasury bonds at current levels. The prospect of lending money to anyone, even the U.S. government, for ten years at barely 2% is quite unappealing.

Conclusion

The events of the past few months have been both surprising and disconcerting. We did not expect the level of damage that the financial markets have experienced. Yet as always, we can only analyze events, look forward, and invest our clients' portfolios appropriately.

We cannot know with confidence what will happen to stocks and bonds over the next few months. The economy will be quite weak in 2009 and corporate earnings will contract sharply. In addition, we are likely to see a number of fair-sized companies fall by the wayside. While we cannot dismiss these signs of weakness, we firmly believe that from an investment point of view, the worst is behind us. At current stock and bond market valuations, investors have already anticipated a dire outcome. And we expect that before too long, investor focus will begin to shift toward the long-term opportunities. Stocks and selected fixed income securities are cheap, there is a lot of available buying power on the sidelines, and declining interest rates are likely to make money market funds and other cash-like investments progressively less attractive. From an investment point of view, we are confident of a positive outcome. It is a question of time horizon.

Remember, the stock market is forward looking. Volatility will continue and stocks may well test or even break the November low before embarking on a sustainable advance, but we strongly believe that investments made in good companies, at these attractive levels, will bear fruit in coming years. This is not the time to get more negative.

We wish all of our clients and friends health, happiness, and favorable investment returns in the New Year.

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