SARGENT BICKHAM LAGUDIS

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Market Commentary and Review

"I predict future happiness for Americans if they can prevent the government from wasting the labors of the people under the pretense of taking care of them."
- Thomas Jefferson

SUMMARY:

2008 was the worst year in the stock market since 1931.

The economy fell off a cliff in the 4th quarter. It is declining at an annual rate of 5% per year currently. What will 2009 bring?

Earnings are still falling, although some analysts predict they will bottom soon.

We got most of our predictions right in 2008, but we did not predict the meltdown. It was a historic year in so many ways – stocks, commodities, bonds.

We are cautiously optimistic about 2009.

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Dear Clients and Friends,

Steve Leuthold refers to his and others annual prediction letters as thermal pollution time. He says predictions are for show, but the real value comes from mid-course adjustments made during the year. This is good advice to keep in mind when listening to forecasts, especially this year. This letter is a little longer than normal due to a review of last year and looking forward to the coming year.

We are entering 2009 with a very weak economy, and while we can look at historical cycles for clues about how things will unfold, things are different this time and there is no good model for what is going to happen next. It was the worst calendar year in the stock market since 1931. The following table summarizes returns for the fourth quarter and the last few years:

	4th Qtr 2008	2008	Last 5 Yrs Annualized
Large Cap (S&P 500)	-21.6	-37.0	-2.2
Large Cap (DJ Industrials)	-18.5	-31.9	-1.3
Mid Cap (S&P 400)	-25.9	-36.4	-0.5
Small Cap (S&P 600)	-25.7	-31.5	0.6
Nasdaq 100	-23.5	-41.9	-3.6
Foreign Stocks (EAFE)	-19.9	-43.1	1.9
Bonds (Lehman Aggregate)	4.6	5.2	4.9
Emerging Markets	-27.6	-53.2	8.1
REITs	-39.1	-38.0	0.8
High Yield Bonds	-17.9	-26.2	-0.6
Commodities (AIG Index)	-31.7	-37.4	0.2
Alternative Assets Group (AAG)	-10.7	-17.6	2.3
65% Equity/ 35% Fixed Income Benchmark	-12.7	-22.2	0.4
50% Equity/ 50% Fixed Income Benchmark	-8.7	-15.9	1.5
35% Equity/ 65% Fixed Income Benchmark	-4.7	-9.6	2.5

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Economy:

At our weekly investment committee meetings, we begin with a review of the economy. This sets the stage for all investment decisions. There is no doubt this will be a historic recession; however, it is important not to get too carried away with expectations of doom. Comparisons with the Great Depression are overblown. Back then, unemployment was 20% - 25% for almost a decade, 50% of the banks went out of business, there was no unemployment insurance, no Social Security, Medicare or Medicaid. The government did little or nothing to improve the situation then, and even made policy errors that made matters worse. There are always people predicting the end of the world, or the end of capitalism, or the end of America, or the collapse of the dollar, etc., etc.; but these should be put in the same category as UFOs... could be true, but very unlikely and not worth planning your life around.

Last year, we outlined eleven factors we thought would drive market returns last year. A quick review follows:

1. Politics / Government has moved to the center of universe. Generally, we would prefer to ignore Washington D.C., but for the foreseeable future it will determine the outcome of the economy and the survival of many companies. We finally had an election and while conservatives are nervous, at least we will fill the power vacuum that has been evident for at least a year. While we initially thought Hank Paulson was doing a good job with the crisis, his bungling of the $700 billion TARP program, failure to stop the collapse of Lehman Brothers, and lack of coherence contributed to the chaos of 2008. Ben Bernanke stands as one of the few officials whose decisions can be admired during this crisis.

2. Federal Reserve policy. The Fed lowered rates to 0% and has taken a number of aggressive actions to stimulate the economy and unfreeze the credit markets. Many of the extreme signs of stress in the credit markets have dissipated. These actions were too late to turn things around in 2008, but should begin to help the economy later in 2009.

3. Credit Crisis. We underestimated the contagion effect of the crisis. This was a big miss.

4. Oil prices have probably never seen the volatility seen last year. After rising to nearly $150, they fell to below $40. This contributed to a slowing economy and rising inflation last year, but will do the opposite this year.

5. Slow economic growth and rising unemployment – still no signs of a turnaround.

6. Slower earnings growth. We estimated growth in operating earnings of 3% last year, which turned out to be wildly optimistic even though it was significantly below consensus.

7. Housing. We did not expect a recovery last year and got this right. While we may see a bottom in housing in 2009, the turnaround will be slow and modest.

8. Foreign trade was a positive as we predicted, but by year end all economies were slowing.

9. The dollar reversed its multi year decline in 2008 as we thought it might, but there are few fundamental reasons to be positive on the forecast.

10. Like oil, commodity prices climbed to historic highs before crashing down. We had the general theme right, but underestimated the degree of both the rise and the fall.

11. We predicted inflation would not become a big issue and were right.

In general, we expected a mild recession and a normal correction / bear market. Through August, we were pretty much on target. Beginning with the takeover of Fannie Mae and accelerating with the Lehman collapse, the credit crisis took things on a whole new course that was worse than we imagined.

What do we think about 2009?

Hurricanes, tornadoes, and even recessions blow themselves out eventually; so we know this recession will end. We think we are in the worst part of this recession right now. Fourth quarter 2008 is likely to show something like -5% growth in GDP, and 1st quarter 2009 will be similar. Job losses have been about 500,000 per month the last two months. It does not take a genius to forecast a weak economy for the near term.

The harder question is to predict when the economy will turn around and what will get it going. There are several signs indicating things may have stabilized, but a few weeks of rebound is not enough to predict an upturn. Commodity and oil prices have turned up from their lows, the shipping index has turned higher, and credit spreads have narrowed indicating there is thawing in the credit freeze. As mentioned, these are early indications of improvement. We are also going to be watching the rate of change of decline of home prices, months supply, and employment trends for early signs of improvement. There is nothing we can point to showing improvement right now. The only hopeful signs are the stimulus programs undertaken both by the Federal Reserve and by Congress. They are committed to spending whatever amount is necessary to get the economy going, and we believe they will be successful, but no one knows how long or how much stimulus it is going to take.

In summary, these will be the factors to watch this year:

1. Housing was what started this decline and we will be looking for signs of a bottom and improvement.

2. Write-offs should end this year, but there are further losses to be taken from credit card loans and commercial real estate.

3. Government stimulus will create some winners and losers. Who is going to get the money?

4. The recession should end in 2009, but some are predicting an even longer recession. Consumer spending is likely to be lower than normal for several years.

5. As the credit market thaws, will banks begin making loans and will businesses and consumers borrow?

6. Inflation is likely to be benign in 2009. We do not expect deflation to be a significant issue, but it will bear watching.

7. When will earnings bottom and begin rising?

Strategic Allocation Decisions – past and future

We started decreasing equity allocations in November 2007 and reached our maximum defensiveness by August. This type of decline, however, makes anyone question their process and strategy. What makes this period especially difficult is that this is the second major bear market in 10 years. There have been four bear markets of -50% in the last century, and we have gone through two of them this decade. This is beyond the probability that most investment strategies are created around, including ours.

As described numerous times, our process is to establish a long-term policy allocation together with our clients, and then work within a range of 60% to about 105% of that policy benchmark. For example, if the policy benchmark is 65% equity and 35% fixed income, then equities will be managed within a range of 40% and 70%. Ninety-five percent of the time, this has proven to be an excellent approach, and has helped us achieve attractive returns during bull markets, and minimize losses during downturns. A 50% decline in stocks, however, coupled with double digit declines in corporate bonds, municipal bonds, commodities, real estate, and even greater declines in foreign markets meant there was no place to hide except in cash or U.S. Treasury bonds.

We have argued again and again against market timing. Granted, by reducing equities to only 60% of our policy benchmark we are engaging in a form of market timing. But after this decline, we are even more convinced about our approach. The bulk of the decline took place in 35 days (October 2 – November 20), a drop of 32%. From that point it recovered 25% in less than 30 days. Trying to be “all in” or “all out” with this kind of volatility is impossible. We will all hear stories from people saying they have been out of the market, but if they were really honest you would probably learn they sold after a substantial decline and did not re-invest until well after the market rebounded.

The caveat to this is that people have to live with the risk in their portfolios. Seeing your life savings fall so precipitously is emotionally damaging. Most people have a breaking point, and when clients hit it we honor their wishes and will sell or offer alternative strategies. We never forget whose money it is, so do not hesitate to call or come in when you are feeling these emotions.

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Today, we are positioning portfolios to be fully invested to their fixed income targets, 60% to 70% invested to their equity targets, with the balance going into the alternative assets and strategies group. Each of these groups are detailed on the following page.

U.S. Stocks:
Our model shows the market to be at its greatest level of undervalued since it was developed. As previously mentioned, we overestimated 2008 earnings, which are still uncertain. Estimates range from $55 to $65, so the P/E on the S&P 500 is between 14x and 16x on trailing earnings. The following table summarizes P/E ratios since 1960:

Inflation	Average P/E
<2%	23.5
2-3%	19.7
3-4%	17.6
4-5%	14.8
5-6%	13.1
6-7%	9.5
>7%	8.5

Core inflation and the GDP price deflator are currently below 2.5%, and falling. Critical to the turnaround will be when earnings bottom and turn higher. Some are predicting this could be in 4Q08 or 1Q09. Most important will likely be when the banks stop writing off billions of dollars from bad loans and investments.

Investment Grade Bonds:
Last year was like an earthquake in the investment grade market. When Lehman Brothers went into bankruptcy, it brought into question the ratings on all bonds. Lehman was a solid A rated credit the day it collapsed. Soon after, dozens of financial companies dropped 25% to 50% in price and many industrial companies had similar falls. As a result, we are much more cautious in committing new capital to individual corporate bonds. We are selectively using mutual funds and exchange traded funds because we agree with analysts who see value in this sector, but we prefer the opportunities we see in the municipal bond market.

We have also found attractive yields in FDIC insured CDs and Treasury Inflation Protected Bonds (TIPS). Mortgage backed bonds guaranteed by the government are also attractive. The common theme is caution and to take advantage of dislocations created by supply and demand.

Alternative Assets Group:
This strategy was not immune to the 4th quarter decline. On average, this strategy lost about 11% in the 4th quarter and 18% for the year. While this is much better than the market's results it is below its history and our expectations.

The quarter's biggest drop was in commodities, which fell 32%; and the best performers were international bonds and gold, which eeked out small gains of 1% to 2%. The balanced managers underperformed expectations with drops of 12% to 15%, and even bond funds such as Loomis Sayles and Nuveen had significant falls. Going forward, we will be re-balancing positions this quarter, but do not expect significant changes. We are not yet ready to pursue REITs or high yield bonds except in very small measures, but there are definite opportunities being created and we will be watching for signs to increase allocations in these under performing sectors.

Last year's meltdown of the hedge fund industry has proven the value of our approach. Many of our competitors embraced hedge funds over the last decade contributing to the meteoric rise in assets. We have never placed a single dollar of client assets in hedge funds. We never liked the fee structure, the lack of regulation, and the lack of disclosure. The Madoff scandal is the largest, but only one of many examples of fraud.

Model Equity: *The Model Equity Portfolio is a real account that we use to test our skills against the market and report our strategies and performance. However, because all our accounts are customized there will be stocks mentioned that will differ from individual portfolios.*

The model equity account outperformed the market in the fourth quarter and for the year. It fell 18.4% vs. 21.9% in the 4th quarter, and -32.2% vs. -37% for the year. While this is a hollow victory, we are still proud to have outperformed the S&P in this account 5 of the last 6 years.

The best performing sectors for us last year were consumer staples and energy; and some of our best decisions were selling positions before the big decline and then not re-investing. Like in our balanced strategies, we are about 75% invested currently and have held higher than normal cash balances all year. Additionally, we were significantly underweighted in financial stocks all year.

Our worst performing sector was industrials and materials. We did not expect the degree of economic decline that unfolded, and we thought the growth in the emerging countries, mining, and energy would continue growing faster than the rest of the economy. In retrospect, we should have anticipated that during a recession you should not expect cyclical companies to outperform. They are not immune to an economic decline. If there had not been a credit crisis, and the recession was milder as we had expected, we may have been right but there is no way to know.

Foreign Equities and Fixed Income:
We began expressing concern about our foreign investments early last year, and we should have been more aggressive in trimming positions. Europe and emerging markets underperformed in the second half of the year by wide margins. EAFE, the large cap international index, was down 34% the second half of the year, and the emerging markets index was down 44%. Longer term, we are positive on emerging markets, and we continue to believe diversification in developed foreign countries is also important. As we have described before, the direction of the dollar is a major determinant on the over or under performance of foreign investments. And, while we are not bullish on the dollar, for it to go down it has to be against other currencies. Something has to go up. We are not bullish on the Euro. The Yen is the only other major currency, and Japan has been in a recession for a decade. As China continues to develop, their currency will probably continue to increase as will other emerging Asian countries.

Deflation:
We have been asked a number of times about deflation. There is little doubt the risks of deflation have risen. Commodity price drops make it likely we will have falling headline inflation rates for many months, but experts generally consider deflation to be a broad based drop in all prices for several years. We consider this outcome to have a small probability of coming to pass primarily because the Fed is engaged in massive monetary easing that will put a floor under inflation.

In 2002, Ben Bernanke gave a speech earning him the nickname Helicopter Ben because of the image of him dropping bails of money out of helicopters. The speech outlined a series of tools the Fed could use to defeat deflation.

1. Create a buffer zone for inflation – acting to prevent inflation from becoming too low as well as too high.

2. Ensure the safety of the financial system and use the discount window to protect the market.

3. Act preemptively and aggressively.

4. Lower rates further out along the term structure by committing to keep rates low for an extended period of time, and/or by buying longer dated securities.

5. Offer fixed term loans to the private sector indirectly via banks through the discount window.

6. Purchase of a broad range of private (risky) assets.

7. The purchase of foreign assets (effectively weakening the dollar).

While the Fed has already done several of these, there are still plenty of options left in its arsenal.

Are you happy with your advisor?
We recently saw a poll that surveyed millionaires and asked whether they were happy with their financial advisors. After a year like we have seen, it should not be too surprising that people are not happy, but it is concerning nonetheless. We hope our clients are not among them and here is what we have tried to do over the last year:

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1. Pro-actively manage portfolios. We made many, many changes to portfolios over the last year to get more defensive.

2. Clarify our strategy. We have tried through these letters, meetings, and phone calls to make sure clients understand our approach. For some clients, we have adjusted allocation policy, but for most it has been a re-confirmation of their existing plan.

3. Communicate our opinions on the economy and the market. We want clients to understand the basis for our decisions and to let us know if they disagree.

4. Communicate, communicate, communicate! We have had hundreds of contacts with clients by email, phone, and face to face meetings.

5. Update financial planning. Many clients have taken advantage of meeting with Gary Powell to update their financial planning projections. We have incorporated a new process of variable returns that utilizes returns from the 1930's in those projections.

While our portfolios still suffered losses last year, the list of catastrophes we missed is long. In hedge funds, people lost 100% of their capital. Some people still have not received their money out of auction rate preferred securities. We had no exposure to Schwab's or anyone else's short term enhanced money funds that had surprising falls. Many hedge funds and funds of funds have been affected by numerous frauds – Madoff only being the biggest. Additionally, hedge funds have frozen access to many investors, not letting them withdraw funds.

If you are not happy in any way with us, please come in or call and let us know what we can do to improve. If you are not currently a client or if you know someone that is not satisfied with their current advisor, please have them call us or let us know and we will call them. We are open for business and accepting new clients.

Financial Planning:

There are so many changes and potential changes to tax law this year that we are going to need to be flexible and diligent in keeping up and communicating with you. Here is a partial list of the changes already made:

- Estate tax exemption raised from $2 million to $3.5 million per person.

- Annual gifts exemption raised from $12,000 to $13,000 per person.

- Required Minimum Distributions from IRAs can be skipped this year.

- IRA distributions can be made directly to charities.

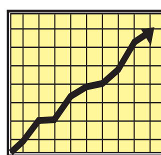
- 401k limit increased to $16,500 from $15,500.

There have been many projections about what taxes might be changed with the new President and Democratic Congress. However, at this time it is all speculation. We will have to wait until specific proposals have been made.

Company News:

As we previously announced, 2008 was our 20th anniversary. We thank those of you who provided names of people for us to contact and remind the rest of you we have received all our clients through referrals, and would be proud to help your friends, family, or associates. Like all businesses it is important for us to continue to grow so we can keep adding the resources to provide you the best possible service and performance. If you know of anyone who might be interested in our services, or simply receive our newsletter, please have them give us a call or check us out at www.sargentbickham.com.

Many happy returns,



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