

3rd Quarter 2008 Stock Market Update

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AT A GLANCE

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In markets like we are experiencing at the present when fear reaches a peak, the temptation is very strong to exclaim "this time it is different" and worry that stock prices will fall indefinitely. We do not believe this mantra. Just like home prices did not keep going up indefinitely, we do not believe all stock prices will continue to remain unrelated to underlying company value. We are not delusional, there has to be a fairly painful economic impact from the worsening financial crisis, we just do not believe the financial world as we know it is coming to an end. At some point, the combination of fear and falling stock prices creates opportunity. As you will read below, the bounce back from crises tends to be abrupt and strong.

Unprecedented is probably the most overused word in the financial press today, but that is because there is no better word to describe what happened in September and October as credit markets virtually seized up. Banks (Washington Mutual and Wachovia) and investment banks (Lehman Brothers and Merrill Lynch) disappeared virtually overnight. The seizure of the credit markets caused businesses that funded their operations through commercial paper and states which fund their operations through short-term debt to worry about how they were going to pay their bills.

The Federal Government has responded with an effort determined not to repeat the mistakes made after the stock market crash in 1929 when the lack of response by the federal government further exacerbated the crisis. After one failed attempt to pass Treasury Secretary Paulson's rescue plan and a market fall of 770 points on the Dow when it failed, both houses of Congress passed the bill on October 3rd. While the plan may not be perfect and was imperfectly presented to the American people, it is a plan.

The rescue plan is not intended to be a bailout (a term which drew the ire of the public), but rather an attempt to improve the climate for lending of all types. Without banks functioning properly, voters will be affected from job loss to not being able to borrow money to buy a car or to send their child to college. There was a recent story making the rounds that illustrates the impact on everybody of a financial crisis. The story is told of a dry cleaner laughing during the crash of 1929 exclaiming that Wall Streeters were getting what they deserved. A few months later he was out of business because no one needed to get their suits cleaned anymore.

Long, Hard Slog

Although the phrase "long, hard slog" was used to describe the involvement of the United States in Iraq, it is a good description of what the United States economy will face before it begins to improve. We do not believe the United States is entering a Great Depression-like recession, which is a period of many years of GDP contraction. There are too many differences. In 1929, the margin rules were much different—investors could borrow up to 75% of the value of a stock purchase. In addition to banks lending money for

individuals to invest, companies actually lent investors money to buy their stock. When the house of cards unraveled in 1929, there was not any FDIC insurance or compensation for unemployed workers. The government barely responded and the Fed did not even lower rates initially.

Even though we will survive the current crisis without tipping to depression, it is going to take a period of many months for the economy to recover. Economists may argue over when the slowdown truly started (1st quarter of this year? Only beginning now?), and the length of time the slowdown will last, but we find very little argument over the fact the effects on the economy are being felt right now and are going to continue.

The average recession in the post-war modern era (since 1945) has lasted 10 months, but according to Merrill Lynch economist David Rosenberg, if you extend the time period back to 1855, the average recession lasts 18 months. In a recession, unemployment normally increases to a level that would put the current rate between 7 1/2% and 8%. Consumers represent 2/3rds of the economy and with credit tightening will not be able to lift the economy in the near term.

What to Expect from Stocks

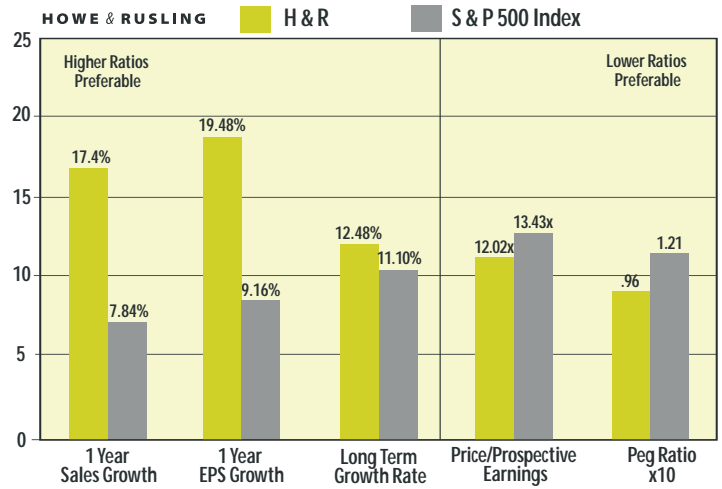
Stock prices typically rise and fall due to changes in the expected earnings growth for the underlying company. In the current crisis, in addition to the weaker economic outlook, many stocks are down as much as they are because investors want liquidity. Despite the near panic in September over concerns about money market funds, assets in money market funds remained near record highs at \$3.34 trillion at the end of September.

We do not typically discuss current holdings because holdings vary somewhat from client to client, but we thought it important to illustrate why we continued to own particular stocks in this crisis even as the stock prices were falling. We did a good job avoiding direct investments in the companies whose stocks have suffered the most—Fannie Mae, Freddie Mac, Wachovia, Lehman, Bear Stearns, AIG, etc. And we bought or continued to own those stocks we felt (and in most cases continue to feel) will be strong survivors and at the end of September are trading at extremely low valuations.

As shown on the chart on top of page 2, despite the fact that the outlook for the sample companies in many of our portfolios remains solid and many of them will come through the downturn stronger our stocks are down similar to the general market. In general, we have been accumulating cash and our last several stock purchases have been dividend paying stocks in sectors which tend to hold up in tougher economic times (although the recent market has not been too discriminating). For those clients with balanced portfolios, our bond management has been very good as we have not compromised on quality nor taken undue risk so the bond portfolios are doing what they are designed to do as part of a balanced approach.



CORE EQUITY CHARACTERISTICS COMPARED TO THE S & P 500 INDEX
(H & R Portfolio as of June 30, 2008)



VIX Index 10/19/90 - 10/10/08



Source: Bloomberg, 2008

MARKET DOWNTURNS AND RECOVERIES 1926-2007

Downturn	% Loss	Recovery
34 months	-83.4%	151 months
6 months	-21.8%	35 months
7 months	-10.2%	5 months
5 months	-15.0%	7 months
6 months	-22.3%	10 months
8 months	-15.6%	6 months
19 months	-29.3%	9 months
21 months	-42.6%	21 months
14 months	-14.1%	5 months
20 months	-16.9%	3 months
3 months	-29.5%	18 months
5 months	-14.7%	4 months
2 months	-15.4%	3 months
25 months	-44.7%	49 months

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3rd Quarter 2008 Bond Market Overview

Behind every dark cloud... Well, you know the rest.

The events of the last quarter in the capital markets have been characterized as "unprecedented" and that adjective will continue to be used in the media for the unforeseeable future. To be sure, this is a time that makes us all wonder if it can get worse or if we'll ever come out of this economic downtrend. The answer is yes, to both. However, it will take time and the understanding that we (the people) are both the problem and the solution.

In spite of declining interest rates over the last quarter, not all fixed income investments performed well. As we can see from the table below, only the safest of fixed income investments (government backed) showed positive returns.

Start Date: 6/30/2008 End Date: 9/30/2008

Index	Return for Period
Intermediate U.S. Government / Credit	-1.19%
U.S Treasury: Intermediate	2.17%
U.S. MBS Agency Fixed Rate MBS	2.04%
U.S. Agency: Intermediate	1.05%
Intermediate: Corporate	-7.04%
Invest. Grade: Industrial - Intermediate	-1.55%
Invest Grade: Financial Institutions - Intermediate	-12.84%
Intermediate Utility	-1.97%
Municipal Bond: 1-10 Yr Blend (1-12)	0.03%

Source: Lehman Brothers, 2008

The safety of government securities is always in demand during times of uncertainty and fear and this time is no different. The market's aversion to any credit risk is at a pinnacle right now and the premiums investors are willing to pay for safety and liquidity are at an extreme. This is most evident for the sectors that performed the best and worst during this quarter.

Best Performing Sectors : 6/30/2008 - 9/30/2008

Index	Return for Period
Supranational - Long	4.00%
U.S. Treasury: 20+ Year	3.95%
U.S. Treasury: Long	2.82%
U.S. Government: Long	2.58%
U.S. Treasury	2.30%

Source: Lehman Brothers, 2008

Worst Performing Sectors : 6/30/2008 - 9/30/2008

Index	Return for Period
Invest Grade: Financial Institutions - Long	-19.01%
Invest Grade: Financial Institutions	-13.79%
Invest Grade: Financial Institutions - Intermediate	-12.84%
Long U.S. Corporate	-10.06%
U.S. Aggregate: A	-10.02%

Source: Lehman Brothers, 2008

The quarterly returns on the financial sector are the worst we've experienced over the last 34 years (Since the Lehman Index started tracking statistics). The last time we had double digit negative quarterly returns in the financial sector was the first quarter of 1980. However, at that time it was not credit risk that was at the center of the problem with financials, it was interest rate risk management. At times like this the popular belief is to be less interested in the "return on capital, but rather the return of capital."

It is understandable that the credit markets would be so risk averse in the aftermath of what transpired within a 10-day span at the beginning of the September:

- **The "de-facto" nationalization of Fannie Mae and Freddie Mac (September 7) -**
The biggest guarantors of Mortgage Backed Loans and biggest financial intermediaries for residential mortgages.

The capital markets work on trust and confidence that counterparties will honor their obligations. The key to stabilizing the current credit market conditions is for banks to regain that trust and confidence. During this climactic period the Federal Reserve and Treasury have been very active and are making extraordinary efforts to keep the liquidity flowing into the banking system and avoiding the potential for system-wide risk.

- **Lehman Brothers** - 4th largest investment banking firm founded in 1850, filed for chapter 11 protection (and liquidation) on September 15, 2008.
- **Merrill Lynch & Co** - largest retail brokerage firm in the country on September 15, 2008 agreed to merge with Bank of America in an effort to avoid the same fate that fell upon Lehman Brothers. The merger is said to have been at the "request" of the Federal Reserve Bank.
- **AIG** - American International Group; largest diversified insurance company in the world was put under government control on September 17, 2008 after experiencing a liquidity crisis and not being able to get private funds for interim financing while they pursued asset sales and new equity capital.
- **September 16, 2008** the Reserve Money Market fund (which was the pioneer of the "Money Market" instrument) closed with a Net Asset Value below \$1, sending investors into a panic that not even the safest of instruments could be trusted.
- **September 17, 2008** continued concern with the remaining two independent brokers; Morgan Stanley, and Goldman Sachs even after reporting positive earnings the day before. Their stock prices dropped precipitously on fears they would be next to fail. Subsequently, both applied (and were accepted) with the Federal Reserve to convert to chartered commercial banks on September 22.

The capital markets work on trust and confidence that counterparties will honor their obligations. The key to stabilizing the current credit market conditions is for banks to regain that trust and confidence. During this climactic period the Federal Reserve and Treasury have been very active and are making extraordinary efforts to keep the liquidity flowing into the banking system and avoiding the potential for system-wide risk. The Treasury has explicitly guaranteed over \$5 Trillion in Fannie Mae and Freddie Mac obligations and MBS (mortgage-backed securities) guarantees. This transfer of obligations also includes the transfer of assets of the two GSE (Government Sponsored Enterprises). Estimates are that ultimately it could cost approximately \$200 billion to back-stop these two if the mortgage market and loans don't improve over time. The Federal Reserve has injected hundreds of billions of dollars of liquidity during this period of time to help the banking system deal with liquidity needs. The Treasury was holding special auctions of T-bills in an effort to help the Federal Reserve's balance sheet because they were depleting their inventory of Treasury bills and notes. The U.S. Treasury extended a fully secured loan to AIG of \$85 billion to help prevent further system wide risk. They also guaranteed approximately \$50 billion in emergency reserves to help the Money Markets stave off the run on their funds.

All of these temporary measures led to the acknowledgement that a more permanent solution would be necessary. A special meeting of the Treasury secretary, the Federal Reserve Chairman, and congressional leaders led to the announcement of a more permanent solution for impaired bank assets in an RTC (Resolution Trust Corp) style recapitalization drawing some parallels to the S&L bailout of the early 90's.

The Troubled Asset Relief Plan (TARP) was passed by both houses of Congress and signed into law on October 3, 2008. The intent of the plan is for a Government sponsored fund to purchase illiquid assets (up to \$700 billion) from banks so that they can ultimately raise new capital and make new loans. Over time, the non-earning assets that are sold into the fund will be restructured and resold, while those assets that are still earning will continue to pay and ultimately would be resold into the market also (hopefully at a gain). Remember not all of these loans or securities are in default. Many still perform (pay their debt service). So why does the Government need to be the "middle man?" Why can't the banks sell directly to the market right now? The simple answer is that the market is so distressed that the

banks would not get a fair price which accurately reflects the economic value of the securities and loans that are currently illiquid. Furthermore, the banks can't afford to keep reflecting these assets at a market value that is non-existent. The Government, on the other hand has the "luxury" of waiting while the market recovers.

If economic conditions improve over time we would expect that the total losses from this program would be less than if we were to allow more and more of our financial institutions to go bankrupt with the consequences that we saw last month of Lehman Brothers bankruptcy. The real issue that needs to be addressed is how we reduce the total debt of our economy or at least ensure that it does not grow to the point where we as a country are in jeopardy of not being able to pay our obligations.

The most likely path is to take a moderate approach to reducing our dependence on debt for consumptive purposes both at the government and state/local and individual levels. This will eventually lead to more taxes most likely, unless we have the appropriate policies in place, policies that would incent companies and governments to invest to make us more productive and competitive in order to grow our capital wealth.

We need capital investment from everywhere. Not just domestic but foreign as well. We need to maintain confidence in our system and our economy. The major advantage the United States has is that with less than 5 percent of the world's population, at about 302 million, the United States accounts, by different measures, for between 20 and 30 percent of world GDP (Gross Domestic Product).

In the near term there is much uncertainty regarding the direction of the economy. We believe that global economies will feel the effects of our financial crisis and we would expect deflationary pressures around the world. Fighting deflationary pressures would mean making money cheap again which ultimately could be inflationary. However, right now inflation is the least of our economic concerns.

What steps have we taken to safeguard your fixed income investments?

Our approach to fixed income investments has always been to diversify risk, not just credit risk but inflation risk as well. Risk management is critical in achieving stable and dependable long-term performance. To that end we invest only in Investment grade bonds; having ratings of "BBB" or better. For the most part, we invest primarily in those bonds rated "A" or better by one or both of the rating agencies (Moody's or S&P).

We seek further diversification within the taxable bond portfolios by underweighting or overweighting certain market sectors depending on economic conditions that we anticipate. We believe that we have done a very good job of anticipating the credit downturn and have for the most part underweighted bonds of financial institutions and overweighted government bonds.

Within the tax-exempt portfolios we have ensured that we diversify across sectors and have sought to overweight more in the General Obligation sector of Municipal bonds versus the Revenue Bond sector of the tax-exempt market.

In the months to come we will all be faced with some very difficult choices and it is unclear how the credit markets will react to attempts to infuse trust into the system. This problem could be compounded by the effects of a recessionary period that lies ahead. While we have taken prudent steps to diversify your fixed income portfolio by limiting exposure to the credit risk associated with any one specific issuer or market sector, those risks cannot be completely eliminated without affecting long-term performance. We are aware of the systemic risks that are present in our economy today and are hopeful that the appropriate government policies will be taken to avoid further economic deterioration. In the meantime we remain vigilant and will act in your best interests to preserve asset values.

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