FREDERIC T. KUTSCHER ASSOCIATES, INC.
Comprehensive financial counsel for individuals, families and trusts

January 30, 2009

2008 R. I. P.
An Enhanced Commitment to Financial Fitness

Usually, when we turn the calendar page, we enjoy the process of digesting the financial news data about the preceding year. Although we can't say we enjoy the contents, we hope you'll find the accompanying review of 2008 interesting.

Before commencing our review of the financial markets of 2008 in all their dark splendor, I'd like to share some of my own thoughts as well as our collective insights about the role financial planning plays in the personal and emotional effects of the severe market declines we've all experienced recently. Quite bluntly, this was a doozy. We can't help but re-examine our role in light of the recent events. Or more succinctly, is comprehensive financial planning relevant in a year like 2008 when the markets cratered, and, if so, did we help?

The events of the last 15 months, particularly since the beginning of September, have inevitably challenged our collective faith in the markets. For that faith to flourish, we must have a reasonable level of confidence that we can regulate our financial markets effectively, that our government can intervene without waste and political favoritism, that our monetary policy can be managed, and that rule of law will prevail over greed.

I am by nature an optimist, and I know my colleagues are as well. But the last five to six months have been <u>awful</u>—hands down the most difficult in our firm's almost twenty year history in terms of our clients' portfolio performance and financial challenges. Bad news arrived daily. Seemingly impossible events occurred. Price declines exceeded virtually all predictions and left even the most seasoned market participants stunned. It was daunting to keep up with the events that were transpiring and formulate coherent advice to our clients.

We repeatedly reached out to clients by email and telephone. We met more frequently with clients. We rebalanced everyone's portfolios when the markets were near their low for 2008, which we hope will enhance returns as particularly hard-hit asset classes recover.

Yet, despite these challenges, and in fact because of them, we are convinced of the benefits of the comprehensive approach to financial planning and the multi-asset diversification. Less than 5% of our clients changed their investment policies in any significant manner during the worst period of 2008 (September-December). This accords with the advice of a host of admired market

Hoge Building
Suite 800
705 Second Avenue
Seattle, Washington
98104-1711

Phone 206/382-4414
Fax 206/382-4412
www.ftkutscher.com

professionals and even the actions they are taking in their personal finances. Please see the enclosed article "Where the Financial Gurus Are Putting Their Own Money."

We saw that our clients overwhelmingly embraced their policies even in the face of withering negative news and price declines. We believe this could not have occurred without their understanding the role their portfolios play in their broader financial planning, which includes cash flow planning to cushion against volatile market events.

In other words, the "weak hands" (investors who invest when markets are perceived to be good and lose their commitment during periods of weak market performance) are typically speculators who have no idea of their long term goals and market behavior. The "strong hands" are more financially fit; they do not overspend, they have systematic savings programs, they have no continuing credit card debt, they plan for their kids' college needs, their mortgages are reasonable in size and terms, their insurance coverage is appropriate for their needs, they understand their tax situation. In short, the more financially fit strong hands are far less likely to make the big financial mistakes like market timing or panic selling. And the statistics are irrefutable that over longer periods (10-15 years) the disciplined strong hand investors obtain better returns, which is why endowments and truly serious investors take the strong hand approach.

In particular, the strong hands now stand to benefit from opportunities that current low market prices offer. We talk about some of those opportunities in the attached review. No matter what happens to the economy this year, a review of financial history makes it apparent that the currently reduced asset values will not persist over the multi-year rolling periods when investors get rewarded for the volatility they must bear.

Too often in the recent past—as markets rose from 2002 to 2007—financial *security* was equated with *immunity* from significant market declines. Many investors were lulled into this belief by several years of rising asset prices. The worst examples are those who gave their money to Bernard Madoff believing in his promise of perpetual positive returns! That assertion alone should have scared all of his investors away.

The extreme events of 2008, which knocked the world's greatest endowments down by 30% to 50%, demonstrate that immunity from declines is illusory. Or stated differently, it is unaffordable. Treasury bills essentially represent immunity against loss, but they yield only 0.23%.[1] Any investor who seeks to preserve the value of his portfolio against spending and inflation must assume some level of market risk. The investment policy selection, which is key in our work with you, is all about finding the right balance between volatility and returns. And although asset class returns converged in the crisis (all went down!), as we come through it we expect that thoughtful diversification will once again improve portfolio performance.

---

[1] At the height of the crisis, the yield on T-bills went negative; fear was so rampant that some investors were willing to pay the government to hold their money.

Financial security, properly understood, is really "financial fitness." As the term implies, financial matters require continuous attention and discipline to keep the interrelated components of one's finances in good balance. There are trade-offs and ongoing decisions. At no point is the task complete, but with determined effort one can stay fiscally healthy and enjoy a life reasonably free from financial fear.

In short, despite the challenges of the past year, our commitment to help our clients obtain financial fitness is not only unshaken, it is amplified. There is a silver lining to this; we already see far greater emphasis on financial fitness from our clients and in the media. Finances are about much more than the present level of the markets—a concept we've known and implemented for almost twenty years.

Best wishes for 2009. And don't hesitate to let us know if we can assist you!

Ted Kutscher

2008 Capital Markets Review

It's difficult to describe financial market events for 2008 except in hyperbolic terms, for example, as being "the worst in memory." But since our goal is to provide context and perspective, we believe it was the speed (even more than the magnitude) of the collapse of credit, the financial markets, and economic indicators that was so shocking. For example, the one-year decline in the US stock market, as measured by the S&P, was roughly comparable to the three year decline of 2000-2002, but the 2008 collapse is broadly viewed as a 1930s' type event. And indeed, US stocks declined 39%, the largest single year decline since 1937.

When we advise clients about investment policy, we review the historical data that suggest the long-term results of investing, as well as the one-year highs and lows. But when extremely rare statistical events (called "thin tails") become real events—and the 2008 statistics rivaled the "worst one year performance" on any policy going back to 1926—the emotional distress is quite real, regardless of one's intellectual preparation.[2] The difficulty now is in re-focusing on the long-term goals when faith is shaken, especially knowing that results after steep declines can be significantly above average.

2008 will also be remembered as the year diversification didn't help investors. Nearly every asset class declined. European stocks fell 46%. Japanese stocks receded 42%. Emerging markets stocks were off 54%. Real estate investment trusts declined 39%. Commodities fell 36% led by a 70% collapse of oil from its July peak of $145 per barrel. Enclosed with this letter is a table that more particularly describes the returns obtained from various asset classes.

How did this happen?

In 2008, unlike in typical periods of market decline where falling values are concentrated in particular asset categories, huge retreats occurred in practically every asset class except US Treasurys. In typical periods, astute investors can employ portfolio theory to navigate away from the steepest declines by reducing the asset categories that are experiencing bubbles and increasing areas of potential value.

---

[2] As one client put it, the recent market declines are like having seasickness for the first time, despite having been warned of it as you put out to sea. No advance description truly prepares you for the experience. And knowing it will pass doesn't save you from the misery.

For example, we were able to do this for our clients by reducing large cap growth stocks in 2000-2002 and emerging market equities in 1996-1997. But last year was atypical, to say the least, since Treasurys were perceived as the only safe haven, as (ironically, some would say) US sovereign debt benefited from the worldwide recoil from credit risk.

In fact, it was the rapid decline in the value of all other bonds which was so difficult for client portfolios. Clients with significant bond allocations rely upon their bonds to moderate the volatility of their portfolios, but the panicked selling of corporate bonds and foreign debt in 2008 really hurt the performance of this portion of client portfolios. Before the market declines took on the pace of a crisis, one of your primary bond management teams, Loomis Sayles, acted on its perception that corporate and foreign bonds were priced better comparatively than Treasurys and acted accordingly. In effect, Loomis did what we pay good managers to do: buy value. But unlike in past periods of severe stock market decline (the Great Depression or the Arab Oil Crisis of 1973-74), corporate bonds did not hold their values. Instead, corporate bonds continued to fall as all credit (other than Uncle Sam's) became suspect and Treasurys continued to climb.

Likewise, many of our stock funds were punished for their willingness to find and invest in value. Unfortunately, many stocks whose prices fell early (and thus attracted value-oriented fund managers) just kept falling. Stocks of financial companies were particularly hard hit. And given that financial company stocks constituted 25% of the S&P 500 before the crisis, the problems to one degree or another were bound to touch nearly every stock fund portfolio. We also believe that certain financial institutions (and their stockholders and bondholders) were unlawfully attacked by short-sellers and unfairly punished by the haphazard nature of the government's early stabilization attempts.

Present opportunities

As of today, Treasurys are probably in a bubble-like condition with yields of less than 3.7% —historically low for the 30-year bond; and when yields rise, bond prices get slammed. Conversely, investment grade corporate bonds are yielding an attractive 8-9% while high yield bonds are yielding 18%. Both of your primary bond managers, PIMCO Total Return and Loomis Sayles Bond, are completely out of the Treasury market. So although Loomis was clobbered in 2008, we are excited about Loomis's current positioning to regain some of the 2008 price declines since we believe corporate bond yields are very attractive and should more than cover the issuer defaults that will increase as the recession progresses.

Likewise, although we would have preferred that all our stock managers had beaten their benchmarks in the past year (they didn't), and even considering the difficulties the economy will have this year and beyond, we are excited by the opportunities represented by current stock prices in terms of future returns. For starters, common stock dividend rates now exceed Treasury yields. And stocks are priced at less than 12 times much-reduced 2009 anticipated earnings. What's more, the panic has caused stock prices to

become relatively compressed, so the market is not differentiating between good companies and great companies. Consequently, we believe the next few years will be target rich for managers who focus on fundamental research. And notwithstanding the recent declines, our stock managers still have admirable 5-year and 10-year track records.

We are confident that over full market cycles these managers will continue to serve us well.

We also took the extraordinary step of rebalancing substantially all client portfolios in November and December except where a recent rebalance or client circumstances suggested otherwise. Part of that rebalance involved making modest allocations to areas that had declined most precipitously: real estate investment trusts, emerging market equities and high yield bonds. We might note that we chose to avoid those asset classes going into the market decline because they started with relatively high valuations.

About investment policy-making after 2008

In the cover piece we discuss the importance of being financially fit as an integral part of good investing. Beyond making sure client portfolios are properly positioned, we are focused more than ever on helping you address all areas of your financial life. In part this is because financial planning is at the core of what we do. And in part because we know, especially at times like these, that if we can help you reduce anxiety by developing understanding and convictions about your financial future, you are more likely to act rationally and not hurt yourself.

In reaction to a crisis like this, two temptations lurk. One is to believe that market declines can be avoided altogether because of the stories in the press and stories we hear word of mouth about "smart" investors who "went to cash." The temptation is to try and anticipate the next leg of decline (there is always another one!), sell in advance and buy back lower. We won't repeat here the well known statistics among investment professionals about the futility of market timing. We will be communicating shortly with more on that.

The second temptation is to change your investment policy now to a radically more defensive stance as a result of the 2008 experience. As David Swensen, who has compiled a terrific track record as head of Yale's endowment, recently remarked, it doesn't make sense for an investor with a long horizon to structure a portfolio to perform well in a period of financial crisis. More simply, Yale would not have been able to grow its endowment so well over the past 20+ years if it had invested defensively by focusing on statistically rare financial crises. While most of our clients are individuals, not endowments, their financial fitness involves understanding that, in their need for spending and their battle against inflation, they cannot live well over their lifetimes on a financial diet of US Treasurys. This is why we do so much work on tailoring an

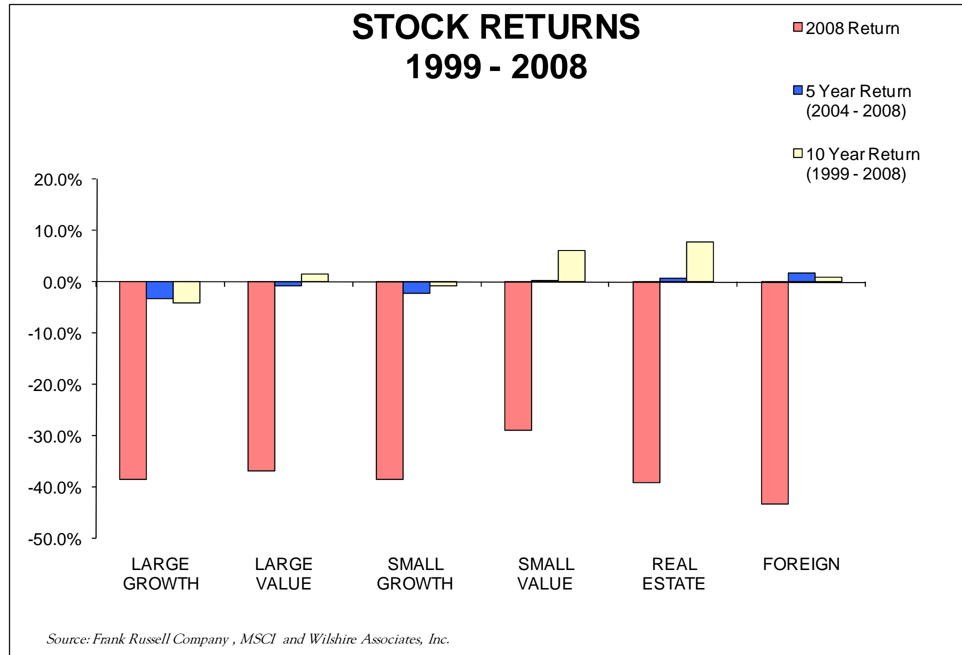
investment policy that is appropriate for your needs. Having said that, the recent market experience may have caused some clients to rethink their willingness or ability to stomach volatility. If this is a concern, we want to talk with you about this very important matter, and if appropriate, help you evolve your portfolio at a pace that is unlikely to cause real damage.

Comprehensive financial planning subjects in 2009

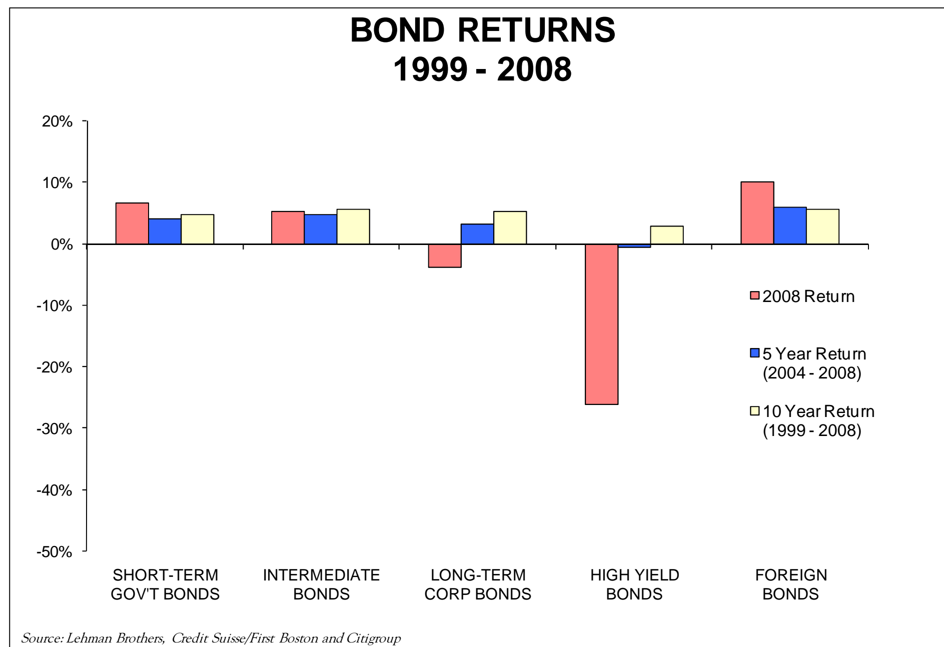
In addition to the continuing cash flow, tax and insurance reviews, we have started reaching out to clients about mortgage refinancing, particularly for those who may

benefit from lower interest rates or who may not have mortgages but wish to reduce their reliance on their portfolio for spending while values are depressed. With a new Congress and President, income and estate tax laws may change, so we will be alert to the implications of those changes on your plan. As you may know, required minimum distributions from IRAs are suspended this year, but we're reviewing the advisability of doing this for each client specifically.

We will be in touch and always look forward to hearing from you.



Source: Frank Russell Company , MSCI and Wilshire Associates, Inc.



Source: Lehman Brothers, Credit Suisse/First Boston and Citigroup

TOTAL RETURNS (annualized)

	1 year (2008)	5 years (2004-2008)	10 years (1999-2008)	COMMENTS
EQUITIES (Stocks & Real Estate)				
US LARGE-CAPITALIZED GROWTH COMPANIES	-38.4%	-3.4%	-4.3%	Equity markets suffered their worst losses since the 1930s in 2008 and large capitalization growth stocks were no exception. Large growth stocks suffered a bit more than large value stocks, but the difference is not material given the scale of declines. Except for 2007, growth stocks have underperformed value stocks since 1999.
US LARGE-CAPITALIZED VALUE COMPANIES	-36.9%	-0.8%	1.4%	Large capitalization value stocks were clobbered in 2008, although they managed to eke out a tiny advantage on large capitalization growth stocks. Since 1999 value has beaten growth every year except in 2007.
US SMALL-CAPITALIZED GROWTH COMPANIES	-38.5%	-2.4%	-0.8%	Small capitalization growth stocks have largely underperformed small capitalization value stocks since 1999 and 2008 was no exception.
US SMALL-CAPITALIZED VALUE COMPANIES	-28.9%	0.3%	6.1%	In the context of falling corporate earnings as the recession got underway, it's no surprise that small capitalization value stocks outperformed small capitalization growth stocks. And unlike in other challenging economic environments, small capitalized stocks outperformed all other equity styles.
REAL ESTATE EQUITIES	-39.2%	0.7%	7.7%	The bull market in REITs that started in 2000 came apart in 2007, when REITs fell much worse than equities. That decline continued in 2008 with REITs falling slight more than US stocks.
FOREIGN STOCKS	-43.4%	1.7%	0.8%	Developed country foreign stocks performed about the same as the US in local currency terms, but underperformed in dollar equivalent as the financial panic caused the dollar to rally. Emerging markets fared considerably worse, ending several years of spectacular performance.

	TOTAL RETURNS (annualized)			
	1 year (2008)	**5 years** (2004-2008)	**10 years** (1999-2008)	**COMMENTS**
CASH EQUIVALENTS				
CASH – MONEY FUNDS	1.7%	3.1%	3.2%	Money market rates dropped as 2008 and the credit crisis wore on and as the Federal Reserve continually cut its lending rate targets.
BONDS				
SHORT-TERM GOVERNMENT BONDS	6.7%	4.1%	4.8%	US government bonds were the lone bright spot in asset classes in 2008. The value of the bonds was driven upward as investors fled stocks and every other form of debt.
INTERMEDIATE BONDS	5.2%	4.7%	5.6%	Largely on the basis of the rally in government bonds, and despite declines in corporate bonds, intermediate bonds as a whole ended 2008 with a modest return.
LONG-TERM CORPORATE BONDS	-3.9%	3.2%	5.3%	Although default rates were low and corporate balance sheets were strong, the financial panic took its toll on corporate bonds as investors fled any form of credit risk.
HIGH-YIELD BONDS	-26.2%	-0.6%	2.9%	Prior to the onset of the credit crisis in 2007, high-yield bond coupons were at historically low spreads above US government bonds. Consequently, as investors demanded wildly higher returns for credit risk, high-yield bonds declined markedly in value.
FOREIGN BONDS	10.1%	6.0%	5.6%	Similar to the flight from stocks in the US, investors overseas fled from stocks in favor of bonds and cash, pushing up bond values in the process.

© Copyright 2009 Frederic T. Kutscher Associates, Inc. All rights reserved