

MEMORANDUM

To: Wurts & Associates Clients
From: Eric Petroff, CFA, Director of Research
Date: July 15, 2008
Re: Mid-Year Market Update

The first half of the year was clearly challenging to both investors' portfolios and their confidence in capital markets as equities fell worldwide, credit woes continued, and the price of oil soared. In spite of this growing gloom, we believe now is not the time for despair, but instead hope as the current market environment sets the stage for higher prospective equity returns and possibly some unique strategic opportunities.

To understand this point of view keep in mind that capital markets are nothing more than cyclical discounting mechanisms. This means that during times of certainty and optimism market perceptions of risk fall, driving prices higher and therefore prospective returns lower. Conversely, uncertainty and pessimism have the opposite effect of driving prices lower and prospective returns higher.

Recent market activity seems to support the idea that market participants are strongly shying away from risky assets. The total US stock market (Dow Jones Wilshire 5000) lost nearly 11% through June 2008. Over the same time international developed market equities (MSCI EAFE) lost nearly 11% in US dollar terms, and were down more than 15% in local currencies; emerging market equities lost nearly 12%. Fixed income investors sought the safety of Treasuries, producing a 2.4% return for the Lehman Intermediate Treasury index, versus 1.1% for the Lehman Aggregate Composite as of June.

The reason for this aversion to risk is straightforward if you consider the overall state of the US economy. New homes sales dropped nearly 40%, the inventory of unsold homes rose nearly 40%, and the delinquency rate for all mortgages grew by almost 40% over the last year through March¹. Furthermore, the credit crisis continues with the failure of IndyMac and talk of a government intervention with Fannie Mae and Freddie Mac. The price of oil isn't helping the situation either. In fact Federal Reserve Chairman Bernanke said the US economy is facing "numerous difficulties" and there is a "high degree of uncertainty" about the Fed's economic outlook.

Fortunately though, we must also keep in mind that economies and markets are cyclical in nature and invariably revert to the mean over time. This means we know that asset prices will neither

¹ Source: Standard & Poors

fall nor rise forever and that they generally gravitate towards their long term average valuations. We also know the US economy will eventually work through its problems and continue growing at a normal pace. These cycles can produce wonderful opportunities for fiduciaries that inherently approach investments from a long term, rational point of view, as opposed to the short term mindset of many investors.

The challenge to fiduciaries is not finding the bottom or top of a market, but simply having the wisdom to marginally position your assets in the correct direction over time. This means it is often a wise course of action to avoid risk when everyone else is embracing it and to embrace risk when no one wants it. Such a practice will necessarily result in a cheaper portfolio over time and therefore higher returns over time, as price is the primary determinant of any investment's return. This is one reason policy rebalancing guidelines exist.

With this logic in mind we find today's market environment to warrant some optimism. To begin with, price declines in the S&P 500 are gradually increasing the attractiveness of US large cap stocks. Lower price-to-earnings ratios and higher dividend yields only bolster expected returns. Moreover we also recognize the S&P 500 has returned only 2.9% over the last ten years which is just above inflation and well below the average return, or any reasonable long term expectation for that matter. We expect rolling 10-year returns to revert to the mean over time, which implies better days for the S&P 500. US large stocks also look attractive in the face of more expensive domestic equities such as small and mid stocks that have trailing 10 year returns of 5%-7% (annualized) greater than the S&P, which seems an unsustainable return premium for holding these assets.

Other broad opportunities may result from the current market turmoil as well. Credit markets have continued to suffer and could offer reasonable reward to take mortgage and corporate credit risk. Furthermore, economic weakness has pushed the dollar to historic lows. This has bolstered returns for US holders of international equities, but is an unsustainable trend that will almost certainly reverse in coming years. And from an even bigger picture standpoint we must be on the lookout for assets that protect against inflation because it is clear the Federal Reserve has chosen to throw money at our problems, which always creates inflationary pressures.

In summary we acknowledge the difficulties facing our economy and investment markets, but believe such times should be welcomed by fiduciaries that have the luxury of viewing the world from a long term time horizon. We remind our clients this economic slowdown will inevitably reverse, and it will do so at a time of its own choosing that we know we can never predict with any accuracy. At the very least we urge our clients to remain within their policy and rebalancing guidelines, but also suggest keeping an open mind to the opportunities that are invariably created during times of market stress.