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From the desk of Eric Barden – Chief Investment Strategist

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For most of 2007, the markets were plodding along with reasonable, if not spectacular gains. Even with all of the bad news from the banking sector, as recently as December 11th, the S&P 500 was trading over 1,500, just a few points from its all time high. The major event in December was the Federal Reserve policy meeting.

The Fed disappointed the market tremendously when it only lowered interest rates by a quarter of a point. Since that date, the S&P 500 has dropped more than 200 points, or a little less than 16%. The recent volatility reflects investor anxiety that the Fed has lost control of the economy risking a major decline in earnings and a major increase in inflation.

So what happens now? 2008 is shaping up to be one of the more interesting years for investors in some time. Confusion and uncertainty abound, which also means that opportunity abounds. The major variables are the performance of the Federal Reserve, investment and consumer banks, corporate earnings and the U.S. consumer.

It's highly unlikely that the Federal Reserve will make the same mistake twice. They will continue to aggressively cut rates. Decisive action by the Federal Reserve will go a long ways towards restoring investor confidence. Regrettably, knowing when investors will flip the switch from fear to greed is as impossible as predicting when over-confidence will shift into panic. Corporate earnings in the first half of 2008 will disappoint. We are very likely in a recession. Historically, earnings decline roughly 15% during the course of a recession. The best we can hope for is that earnings bounce back in the second half of 2008.

As interest rates come down, corporate financing costs decline, and for most companies, lower financing costs are the most important factor to improving profit margins. Lower interest rates are the key to higher earnings growth and stock prices in the second half of 2008 and into 2009. The S&P 500 reached an all-time high on October 9th. How long ago that now seems. To recap the last six months or so, many of the largest Wall Street investment banks heavily invested in "Collateralized Debt Obligations" or "CDOs." In short, CDOs are debt instruments marketed to hedge funds, pension funds and large endowments. These securities own debt that is tied to credit cards, auto loans, and of course home mortgages. As the home mortgage market experienced unexpected distress, the rate of defaults increased.

We are now in the middle of the process of investment banks coming clean about their soured investments. Historically, this process can take between twelve to eighteen months. As is often the case, when uncertainties like this are discovered, investors tend to sell first and ask questions later.

The primary risk of a banking panic lies not with the banks themselves, but with international monetary policy makers. The temptation for central bankers is to place too much emphasis on

historic measures of economic growth and inflation. They are often slow to adjust to the new reality that after a debt crisis, banks are much more reluctant to lend. If this tendency is not offset by declining interest rates, the economy can fall into recession.

Since July of 2007, the market has behaved as if a recession was a substantial possibility. Bonds have rallied and stocks have suffered. Sectors that hold up best during a recession like health care and utilities have outperformed the economically sensitive portions of the market. It seems that some kind of recession is already built into the prices of stocks. Assuming that the issues that led to this recession are similar to situations that have arisen in the past, it's likely that much of the worst damage has already been inflicted on stock prices.

In spite of the Federal Reserve's deliberate reduction of the rates that are under their control, market based interest rates have fallen dramatically. There is little real value in owning low-risk securities that are yielding less than 2% annually. At the same time, stocks are now trading for lower valuations than they were during the worst periods of the bear market that ended in 2002. Historically, when valuations are this low, and the risk free rate is as low as it is currently, stocks have been very compelling buys.

Understandably, investors are always taken aback by a sudden increase in market volatility. Even after declines much more severe than what we have suffered lately, stock prices typically fully recover within a couple of years. Temporary economic weakness and the resulting decline in earnings notwithstanding, long-term corporate profit prospects remain intact. Ultimately, long-term profit prospects will determine each company's stock price.

Overall, U.S. corporations are surprisingly healthy. Profit margins remain near all-time highs, and balance sheets are very strong. Once the markets stabilize and the economy recovers, there is little reason to doubt that stocks will be the most productive assets for investors to own. Our portfolios have outperformed the S&P 500 primarily due to a substantial investment in international markets. Emerging markets in Asia and Latin America turned in the strongest performance. Our stock portfolios also benefited from a substantial underweight in consumer and financial stocks.

The core of our investment strategy is to own a portfolio of companies that are undervalued and that have positive attributes that suggest a high likelihood of gaining investor recognition. For U.S. based stocks, some of these attributes are earnings stability and predictability, sustainable earnings growth based on positive cash flow, and substantial international revenue streams. Roughly one-third of the portfolios are directly invested in international companies. This has helped us to maintain decent returns, without substantially increasing the volatility of the portfolios. The combination of productive U.S. stocks and outperforming international stocks has allowed us to achieve returns in excess of the S&P 500, with lower volatility. This is our primary investment objective, and so far, we are effectively executing our strategically diverse approach.

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