

CRISIS OF CONFIDENCE



nvest
WEALTH STRATEGIES

- The unwinding of the US financial crisis
- Unprecedented Government Policy Response
- Future Outlook & Thoughts

October 14, 2008

Words of Emotion:

Why Now?

Irrational Exasperation

Devastating

Terrifying Speed

Insecure

Alarming

Gut-wrenching

Heavily Impaired

Disbelief

Denial


Angry

Pandemonium

Relentless

Outside the envelope

Nervous

The background features a 3D effect of a book cover. The cover is light gray with a brown bird's nest illustration. The nest contains three white eggs. The text is overlaid on this graphic.

The Unwinding of the US Financial Crisis

What is Cause of Crisis?

- **Root: Easy money policies of 12-15 years ago**
 - Leverage cuts both ways
- **Today: Ramifications of De-Leveraging**
 - Hits all assets, driving down values
 - 90% of Sell-Off
 - 3Q: Most liquid investments off 20% - 22%
 - Most Illiquid investments break-even
 - Hedge Funds used leverage 20x to 40x assets
 - **Seismic Swings → Now must raise huge sums of cash FAST**

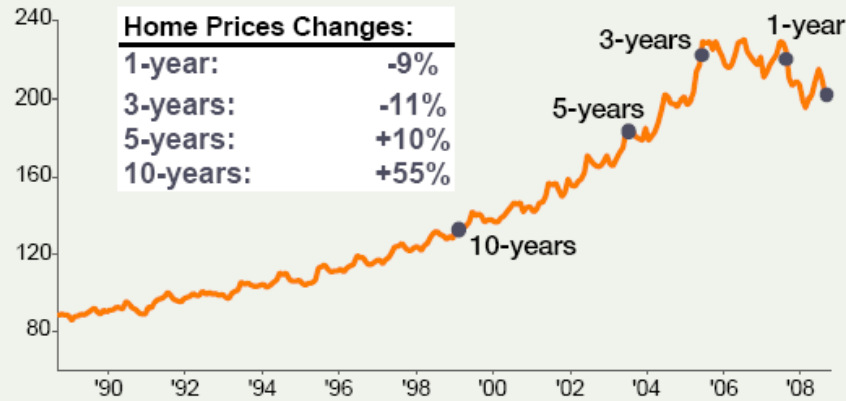
The Aftermath of the Housing Bubble

Market Insight Series

Economy

Median Home Prices

Thousands, non-seasonally adjusted



Unsold New Homes

Thousands, seasonally adjusted



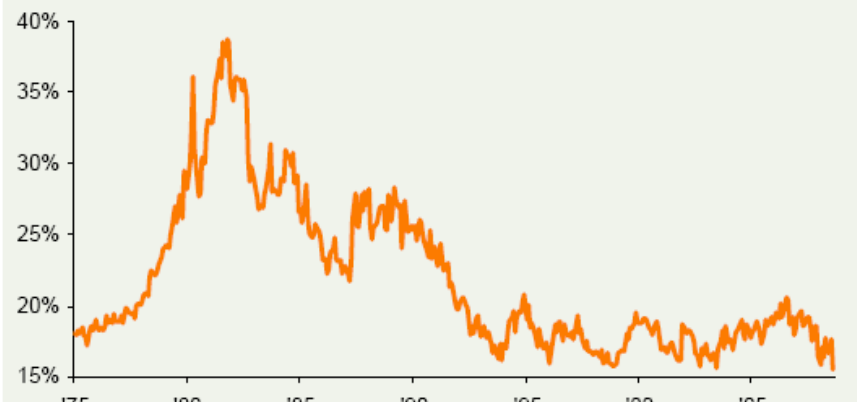
Housing Starts

Thousands, seasonally adjusted annual rate



Mortgage Payment on Average New Home

% of average household personal income



Source: Census Bureau, FactSet, EcoWin, JPMorgan Asset Management.

Data reflects most recently available as of 9/30/08.

Home price based on median sales price of existing homes and are cumulative, not annualized. Existing-home sales include single-family, townhomes, condominiums and co-ops.

Source: (top chart) Census Bureau, FactSet, EcoWin, JPMorgan Asset Management.

Source: (bottom chart) Census Bureau, Federal Reserve Board, BEA, JPMorgan Asset Management.

Data reflects most recently available as of 9/30/08.

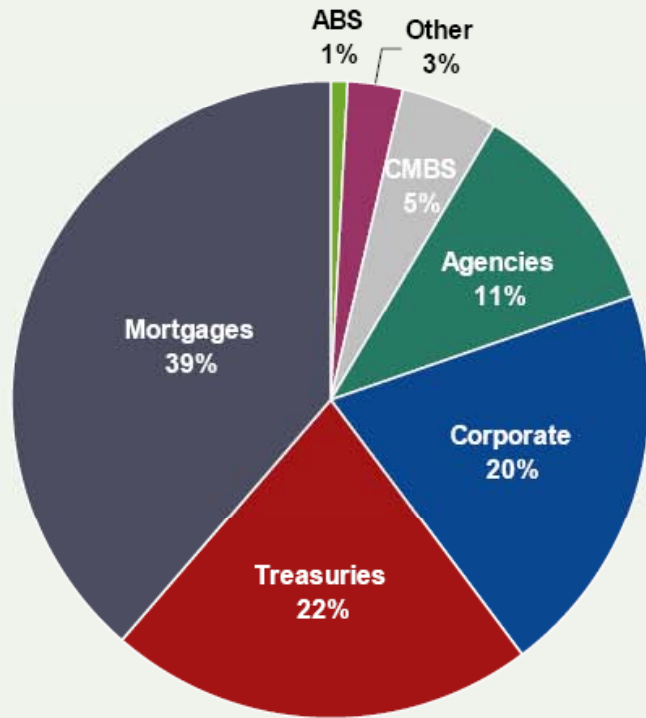
JPMorgan
Asset Management

Fixed Income Market Breakdown

Market Insight Series

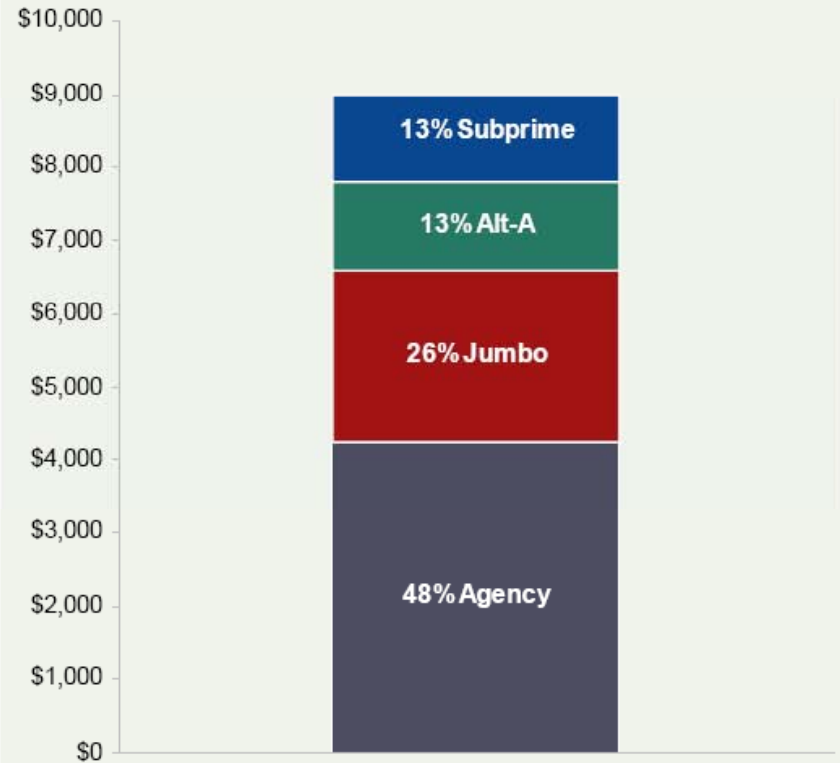
Fixed Income

Lehman U.S. Aggregate by Sector



Source: Lehman Brothers, Federal Reserve, JPMorgan Asset Management. Data are now made available by Barclays Capital Inc.
All weights are as of 5/30/08.

Total Mortgage Outstanding Components (\$bn)



Source: Lehman Brothers, JPMorgan Asset Management. Data are now made available by Barclays Capital Inc.
Data are as of 12/31/07.

Worst Crisis, 15th Worst Decline?

Date Beginning	Date End	Magnitude	Duration
9/3/1929	7/8/1932	-86.1%	713
3/10/1937	4/28/1942	-60.0%	1,284
3/24/2000	10/9/2002	-49.1%	637
1/19/1906	11/15/1907	-48.5%	459
1/11/1973	10/3/1974	-48.2%	436
6/17/1901	11/9/1903	-46.1%	602
11/3/1919	12/21/1920	-44.2%	283
11/21/1916	12/19/1917	-40.1%	268
11/29/1968	5/26/1970	-36.1%	369
8/25/1987	12/4/1987	-33.5%	71
5/29/1946	6/13/1949	-29.6%	761
11/19/1909	7/30/1914	-29.0%	1,178
12/11/1961	6/26/1962	-27.7%	136
11/28/1980	8/12/1982	-27.1%	430
10/9/2007	9/22/2008	-22.9%	240
2/9/1966	10/7/1966	-22.2%	167
8/2/1956	10/22/1957	-21.6%	307
7/16/1990	10/11/1990	-19.9%	62
9/21/1976	3/6/1978	-19.4%	366
8/3/1959	10/25/1960	-13.9%	311

S&P 500 Index

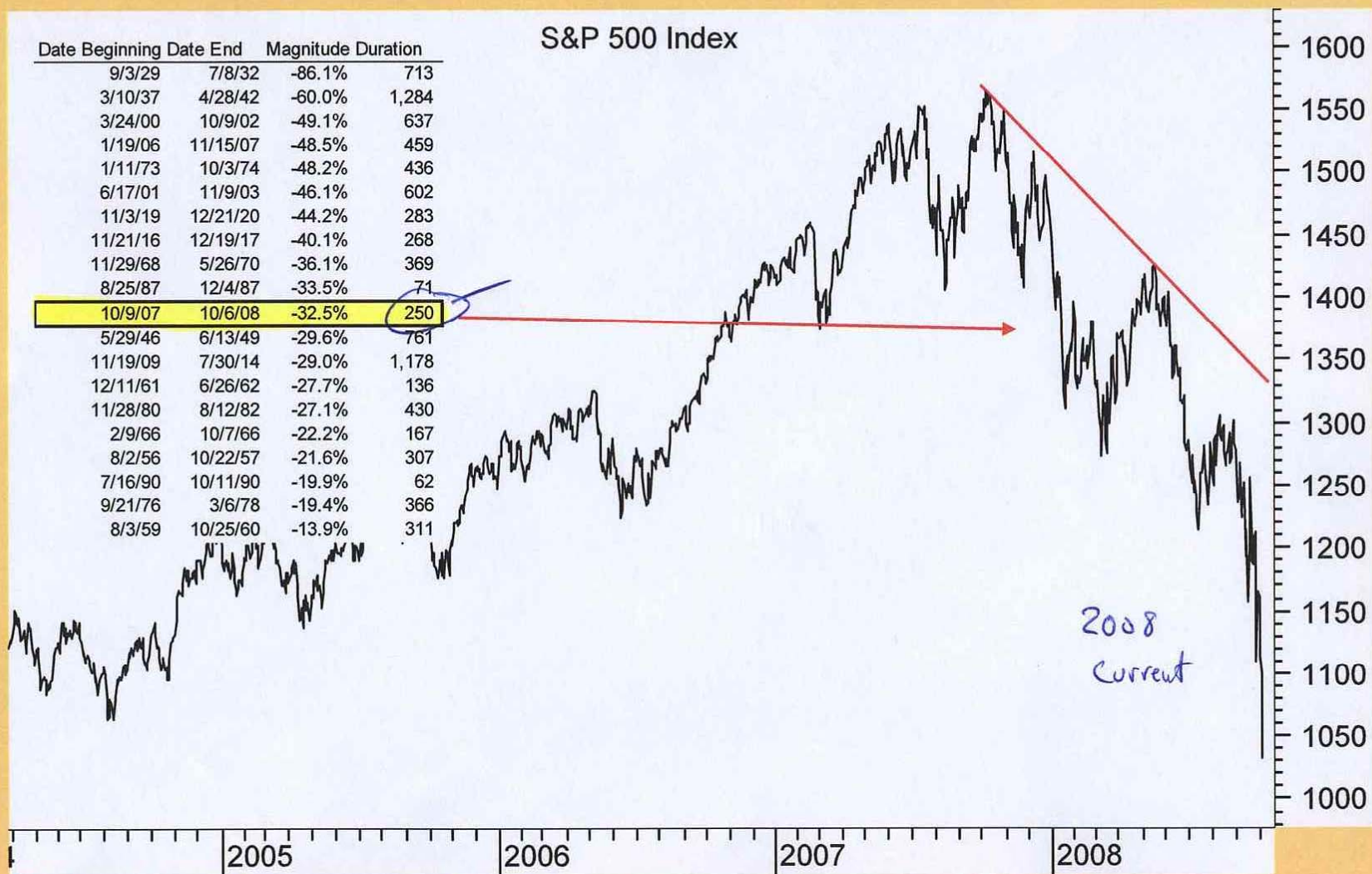


✓ 9/23/2008

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Worst Crisis, 11th Worst Decline?



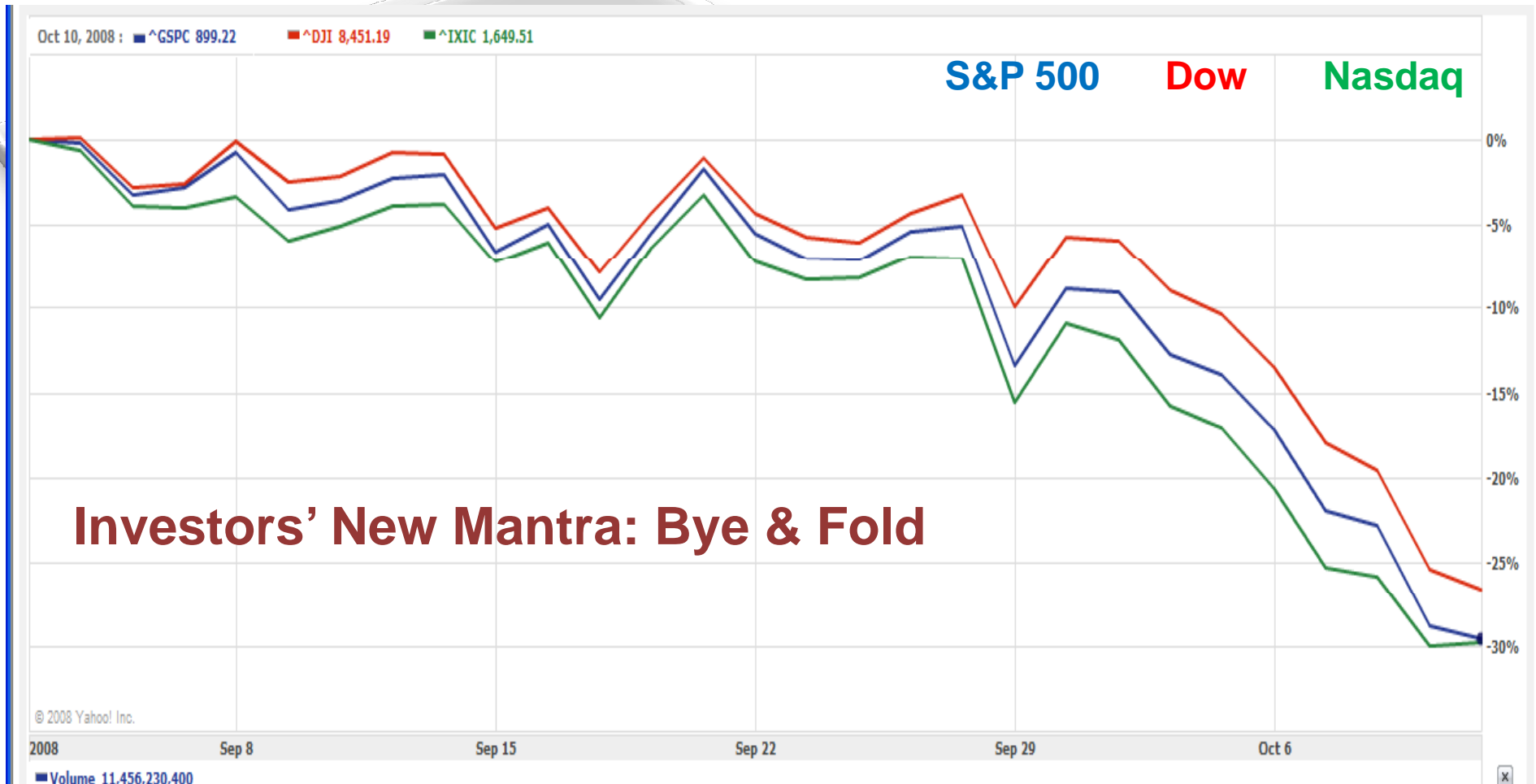
✓ 10/7/2008

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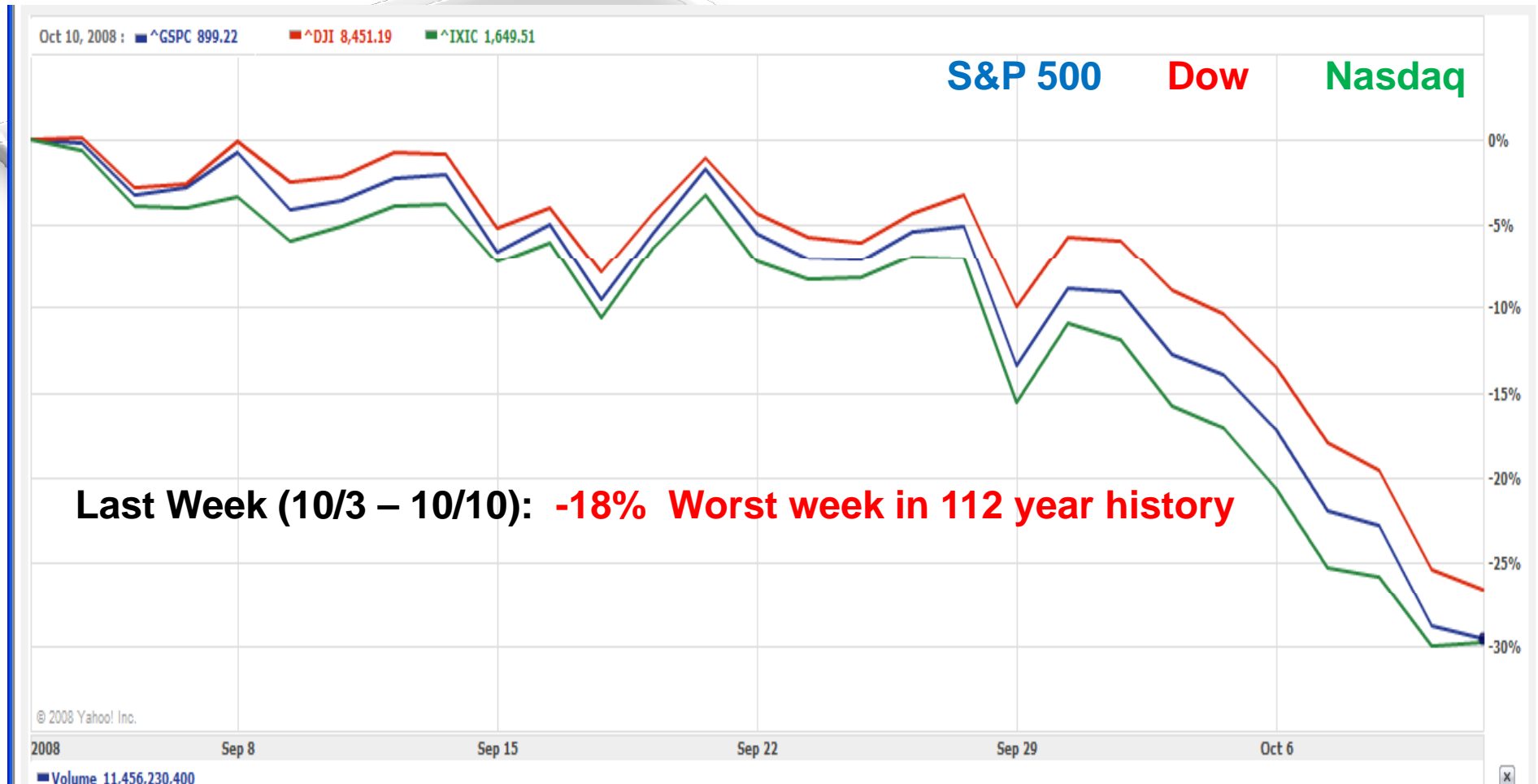
Stocks Oversold, But Fear Reigns

9/1/2008 – 10/10/2008



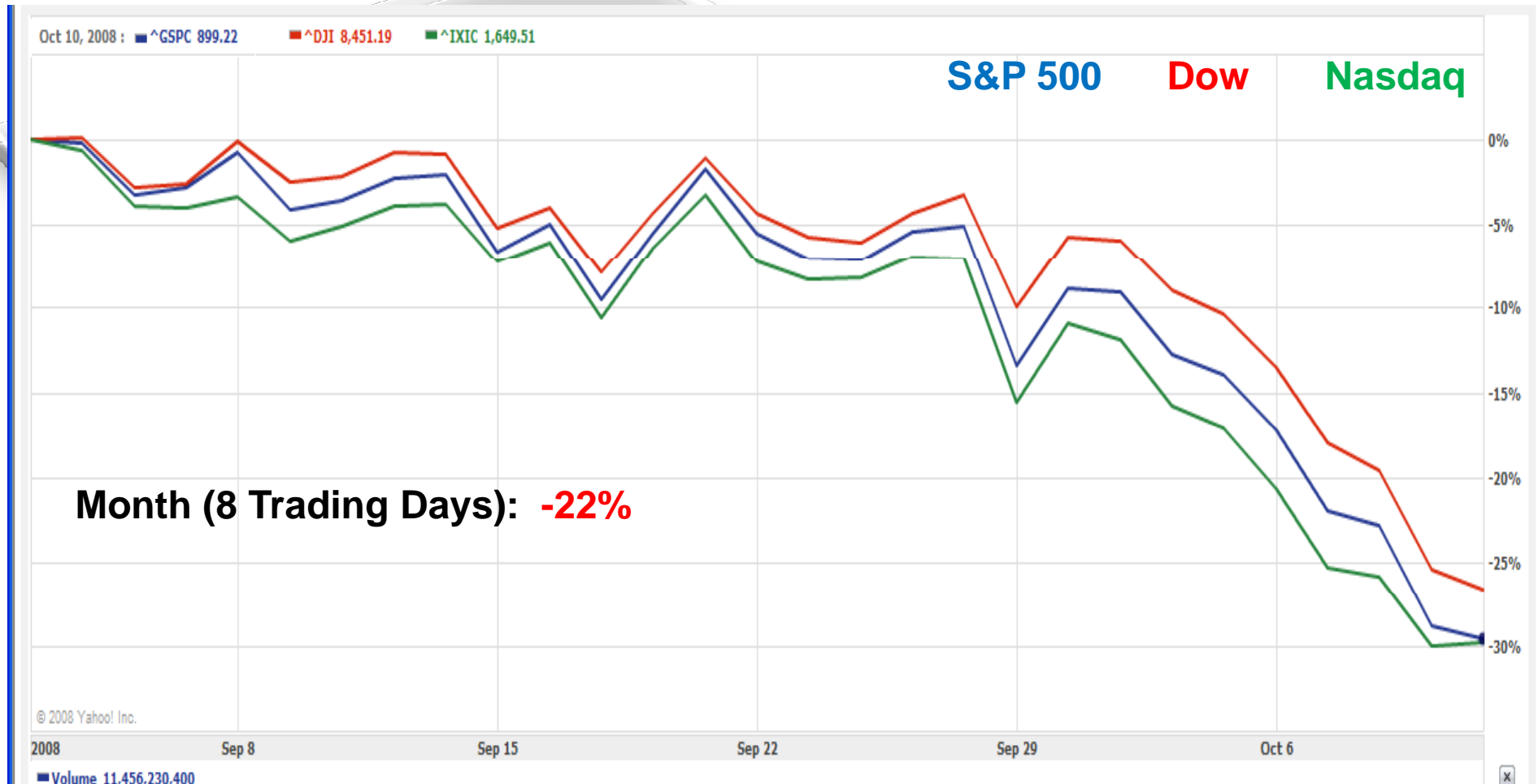
Stocks Oversold, But Fear Reigns

9/1/2008 – 10/10/2008



Stocks Oversold, But Fear Reigns

9/1/2008 – 10/10/2008



...and Painful 12 Months



October 2007 – Present: -40% Worst Since 1970's

- 98% of NYSE stocks below 200-day moving average
- 81% of NYSE stocks at 52-week lows

S&P 500: October 9, 2009 – October 8, 2008

September – Nowhere to Hide

	Value	Month Blend	Growth
Large	-8.33%	-9.68%	-12.22%
Mid	-10.11%	-11.75%	-13.87%
Small	-6.77%	-9.34%	-11.17%
International	-12.43%	-13.37%	-15.41%

	Value	Year-to-Date Blend	Growth
Large	-19.90%	-20.25%	-22.74%
Mid	-17.09%	-18.50%	-23.78%
Small	-9.51%	-14.03%	-20.21%
International	-28.08%	-29.25%	-30.91%

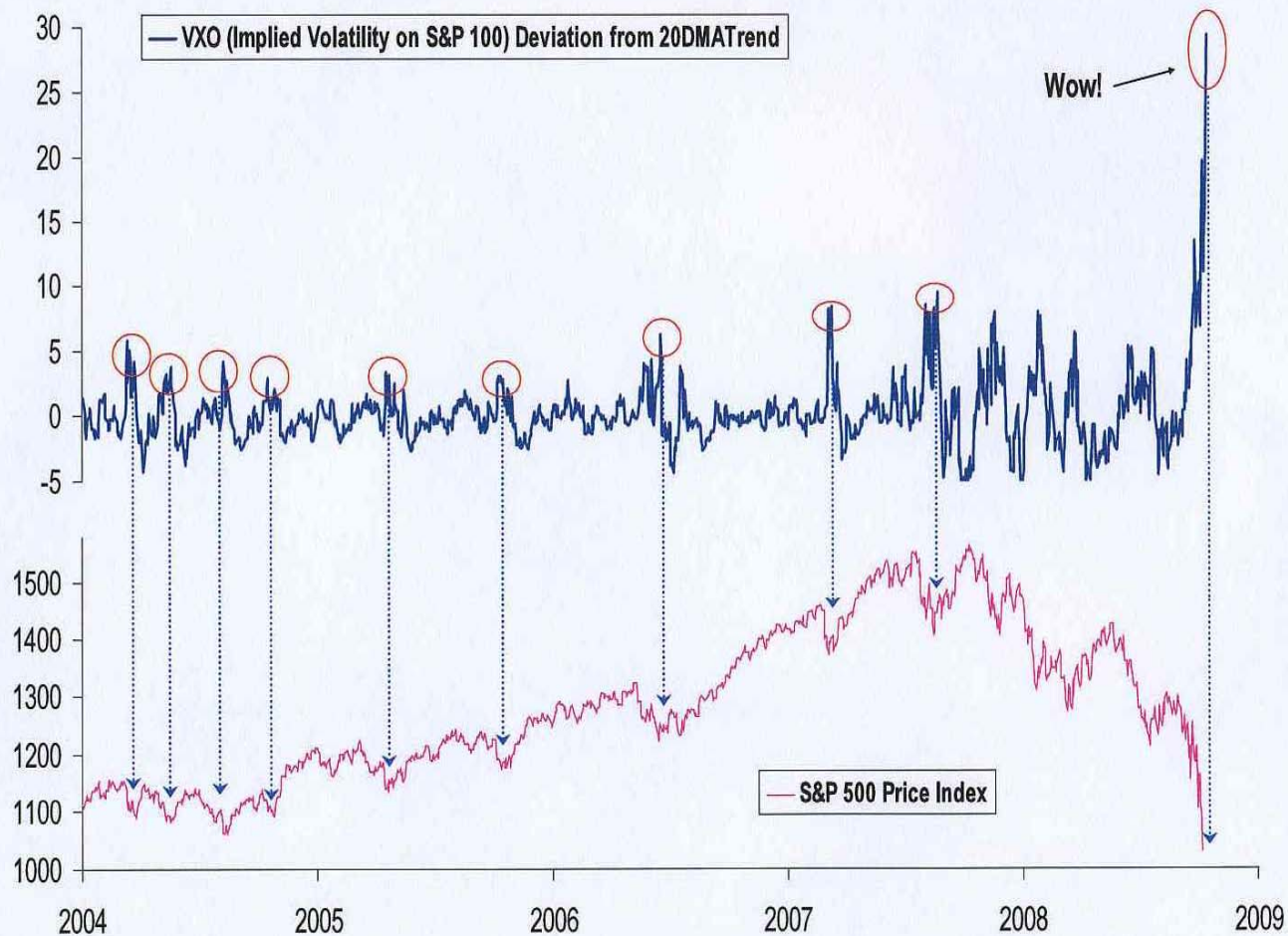
Last Week – One for the Books

	Value	Last Week Blend	Growth
Large	-19.44%	-17.54%	-15.36%
Mid	-19.47%	-18.26%	-17.25%
Small	-20.58%	-19.89%	-18.36%

	Value	Year-to-Date Blend	Growth
Large	-38.20%	-36.87%	-38.43%
Mid	-37.63%	-37.19%	-41.73%
Small	-32.91%	-35.35%	-39.89%

The Starting Point ... A Market Gripped By Fear!

Biggest Volatility Spike Since 1987!



A Lousy Decade



S&P 500: December 27, 1999 – October 10, 2008

The Dow Jones Industrial Average since 1900

Market Insight Series

Dow Jones Industrial Index, Price Return (since 1900)



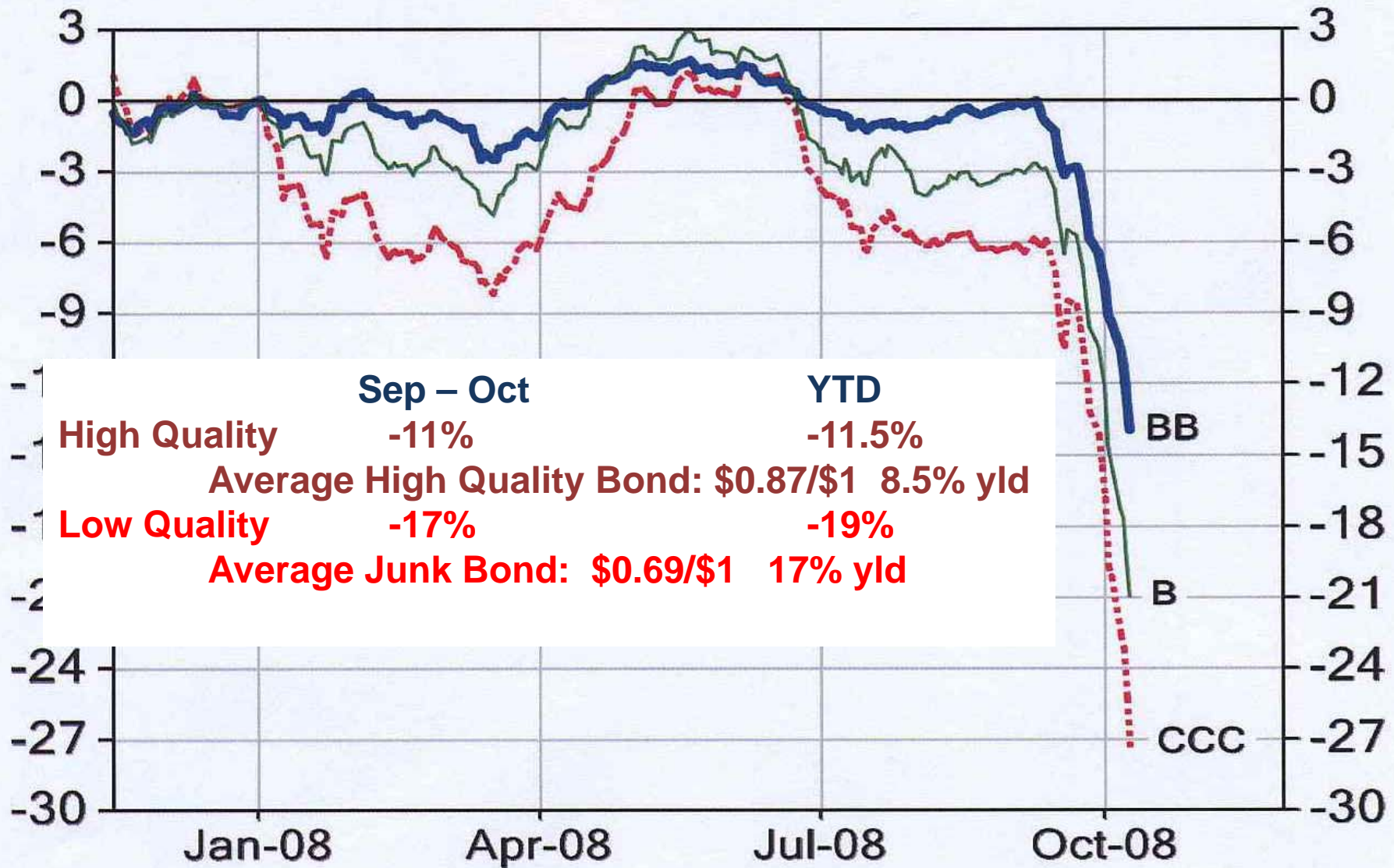
Source: IDC, FactSet, JPMorgan Asset Management.
Data shown in log scale to best illustrate long-term index patterns. Data are as of 9/30/08.
Past performance is not indicative of future returns. Chart is for illustrative purposes only.

Asset Class

Stress in Credit Continues



Bonds – Low Quality, Low Returns



How Low Can The Market Go???

- Trends tend to overshoot (up or down)
- Benjamin Graham – “abyss of Great Depression”
 - Today:
 - 3,518 stocks (38%) trade at less than 8x P/E, or half of long-term average valuation
 - Nearly 1 in 10 stocks (876) trade below cash on books.
 - Example: Schwab (SCHW) holds \$27.8 billion cash vs. \$21.0 billion market capitalization
- Market is wrong (as always) on major judgments

History Isn't About to Repeat Itself

“A long streak of speculative lending got out of hand as banks and even staid industrial companies made a stream of risky loans. Consumer spending on cars and clothes was slipping, but no one was paying attention. The stock market grew shaky in September, and then in October, the bottom fell out. Suddenly, everyone seemed to want to sell. ...It was panic. ...the year was 1929” - WSJ October 8, 2009

1929 vs 2008

1929

- Banks expanded loans to even the most unpredictable of assets, including stocks.
- 300 banks closed in 1929; 1,000 in 1930 with NO FDIC.
- Fed was not responsive; did not cut rates.
- Long reluctance to acknowledge a problem.
- Unemployment climbed toward 25%.
- 44% of all mortgages were in default

President Hoover (1929): “I am convinced we have re-established confidence”

Treasury Secretary Mellon (1929): “I see nothing in the present situation that is either menacing or warrants pessimism.”

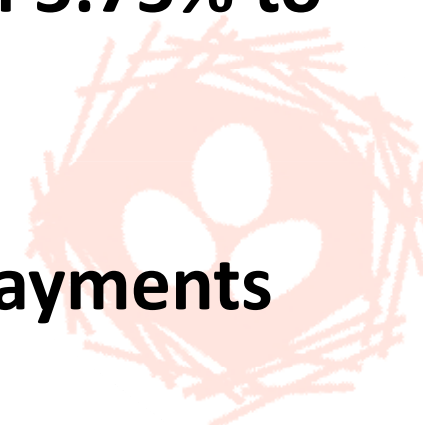


Unprecedented Government Policy Response



2008

- **Government has acknowledged problem AND has taken significant policy action.**
 - FDIC exists, and has been increased – all deposits
 - Government guarantee of money market funds
 - Purchases of commercial paper
- **Aggressively cut interest rates from 5.75% to 1.50%.**
- **Unemployment still below 7%**
- **6.4% of mortgages are 1 or more payments behind; 2.75% are in foreclosure.**



Enormous Policy Response

There Is A Lot Of Easing In The Pipeline

- **Interest rates:** Fed Funds cut -325bp
- **Liquidity:**
 - Discount rate cut -75bp more than fed funds
 - TAF created and expanded
 - Fed initiated \$100 billion in repo with primary dealers
 - TSLF created and expanded several times
 - Fed extends credit to primary dealers including investment banks (PDCF)
 - Fed expands acceptable collateral for TSLF several times
 - Fed lengthens max maturity of primary credit loans
 - Fed expands collateral eligible at PDCF
 - Fed temporarily permits banks to provide liquidity to affiliates (including broker dealers)
 - Fed allows banks to buy ABCP from affiliated money funds
- **Coordinated central bank actions**
 - Fed expands reciprocal swap lines with ECN and SNB
 - BoC, BoE, ECB inject liquidity
 - BoC and BoE cut policy rates
 - Central banks inject \$250 billion of liquidity
- **Fiscal stimulus**
 - Tax rebates
 - Bonus depreciation
- **Support for housing**
 - “Project Lifeline” to reduce foreclosures
 - Raise conforming mortgage loan limit
 - States provide mortgage aid
 - FHA starts to lend to subprime
 - Federal Home Loans Banks increase lending
 - OFHEO eases FNM, FRE capital requirements
 - Housing and Economic Recovery Act of 2008 provides \$300 billion aid to insure mortgages
 - Housing and Economic Recovery Act of 2008 provides backstop for FNM, FRE
 - Treasury puts FNM, FRE into conservatorship (lower mortgage rates)
- **Other**
 - Fed intervenes on Bear Stearns
 - Department of Education provides student loans
 - Fed/Treasury intervene on AIG
 - Fed/Treasury seek “RTC-like” corporation
 - SEC restricts short-selling
 - Bank regulators ease capital requirements for mergers
 - Treasury insures publicly held money market mutual funds for one year
 - U.S. Treasury proposal to buy ‘troubled assets’ (\$700b)

(source: ISI Economics)

Enormous Policy Response (Cont.)

- **Government purchases of Commercial Paper**
- **\$250 billion of direct equity investment in US Banks by Treasury via Preferred Equity shares**
- **Global emergency short-term interest rate cuts**
- **FDIC Guarantee of non-interest bearing accounts (business checking accounts)**
- **New lending facilities for state and local governments (anticipated)**

First Steps of \$700 Billion Rescue Plan

- **Purchasing troubled mortgage-backed securities**
- **Buying mortgages, particularly from regional banks**
- **Insuring mortgage-backed securities and mortgages**
- **Purchasing equity in a broad array of financial institutions**
- **Help delinquent borrowers stay in their homes**

Historically, Government Intervention Has Been Profitable

Current and Historical Financial Interventions by Federal Government

Beneficiary	Action	Financial Commitment	Cost to Treasury
U.S. Airlines (9/22/01)	Loan Guarantees	Up to \$10bn	None except implicit value of loan guarantees; under \$2bn in loans made.
Savings and Loan Failures (8/9/89)	Savings and Loan Failures and Insolvency of Federal Savings and Loan Insurance Corporation	Full faith and credit backing of Federal Savings and Loan Insurance Corporation	\$150bn.
Chrysler (1/7/80)	Loan Guarantees	\$1.5bn	\$311mm profit from sale of warrants.
New York City (8/9/78)	Loan Guarantees	\$1.65bn in guaranteed bonds	None, except implicit value of loan guarantee.
New York City (12/9/75)	Short-Term Loans	\$2.3bn	None, except implicit value of loan guarantee.
Penn Central (1/2/74)	Loan Guarantees in the wake of Railroad Bankruptcy	\$125mm in loan guarantees; \$7bn in federal operating subsidies	\$3bn net loss after sale of ownership stake (and implicit value of loan guarantee).
Lockheed (8/9/71)	Loan Guarantees	\$250mm of loans guaranteed for five years with three year renewal; guarantee and commitment fees charged	\$31mm profit from sale of warrants less the lost value of loan guarantee.



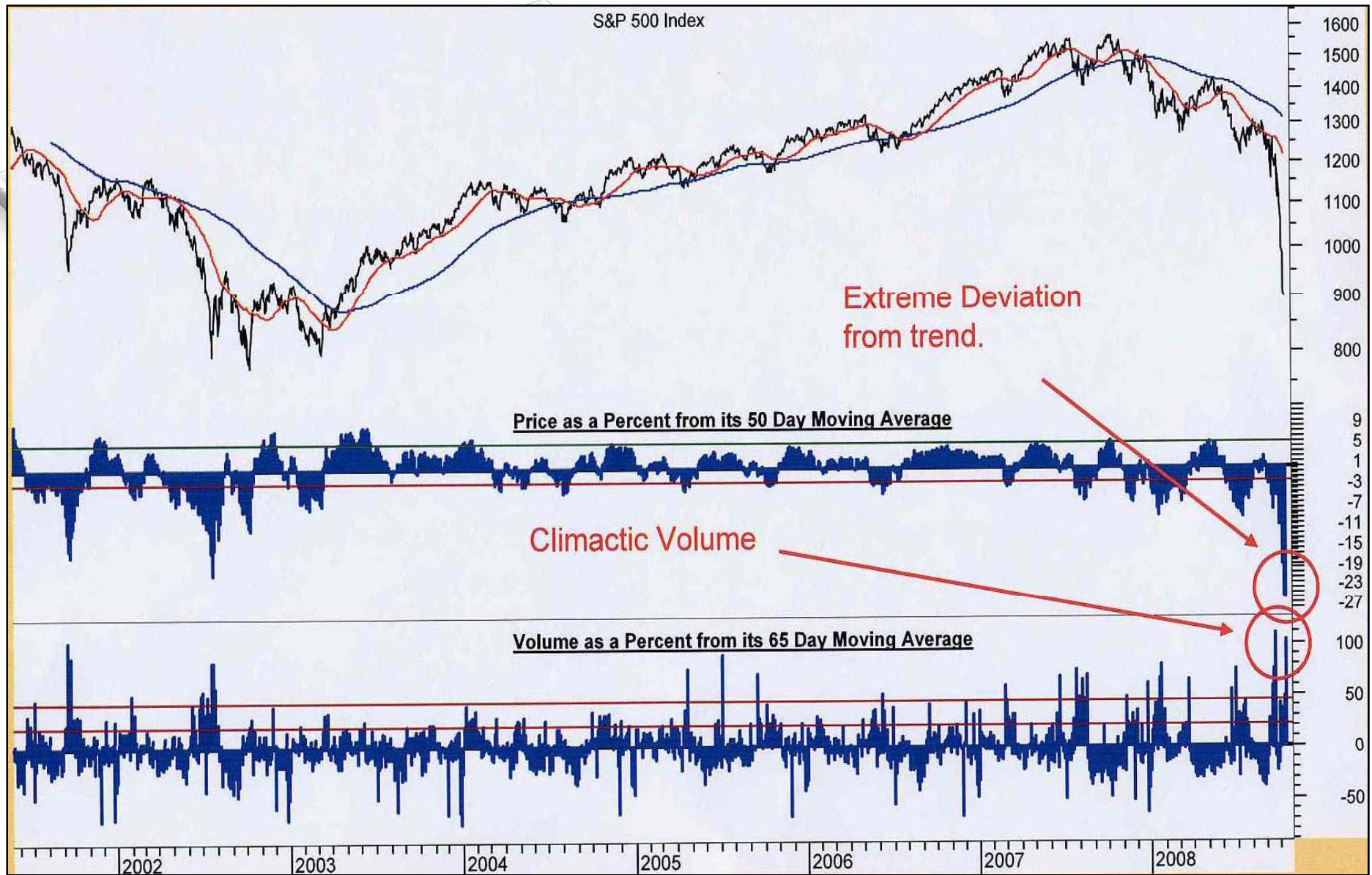
Future Outlook & Thoughts



What We Expect

- **Problems for the economy will take time to work through. Economy likely to get worse before it improves.**
 - **Recession is probably here; will avoid 1929-like depression**
 - **This is a consumer-led recession; consumer will lead us back out when housing stabilizes.**
- **Government policy response will get the upper hand on the crisis and fear.**

What Will the Bottom Look Like...



Will the Stock Recovery Look like a “V”?



Will the Stock Recovery Look like a “W”?



Monday's 11.6% Rally is #5

S&P 500 Index*

20 biggest down days

10/19/1987	224.84	-20.47%
10/28/1929	22.74	-12.34%
10/29/1929	20.43	-10.16%
11/6/1929	20.61	-9.61%
10/18/1937	10.76	-9.34%
7/20/1933	10.57	-8.90%
9/29/2008	1106.42	-8.81%
7/21/1933	9.65	-8.70%
10/26/1987	227.67	-8.28%
10/5/1932	7.39	-8.14%
8/12/1932	7.00	-8.10%
7/26/1934	8.36	-7.91%
5/31/1932	4.47	-7.79%
10/9/2008	909.92	-7.62%
5/14/1940	10.29	-7.37%
9/24/1931	10.68	-7.32%
9/12/1932	8.15	-7.17%
6/15/1933	9.74	-6.98%
10/27/1997	876.98	-6.87%
10/7/1932	7.03	-6.85%

20 biggest up days

3/15/1933	6.81	16.60%
10/30/1929	22.99	12.53%
10/6/1931	9.91	12.43%
9/21/1932	8.51	11.74%
10/13/2008	1003.35	11.58%
9/5/1939	12.64	9.61%
4/20/1933	7.82	9.52%
10/21/1987	258.38	9.10%
11/14/1929	19.24	8.95%
8/3/1932	6.39	8.80%
10/8/1931	10.62	8.49%
2/11/1932	8.12	8.40%
2/13/1932	8.80	8.37%
12/18/1931	8.36	8.32%
7/24/1933	10.50	8.17%
6/3/1931	13.12	7.53%
10/20/1937	11.93	7.49%
11/10/1932	7.44	7.45%
6/10/1932	4.91	7.44%
5/6/1932	6.10	7.32%

Source: globalfinancialdata.com

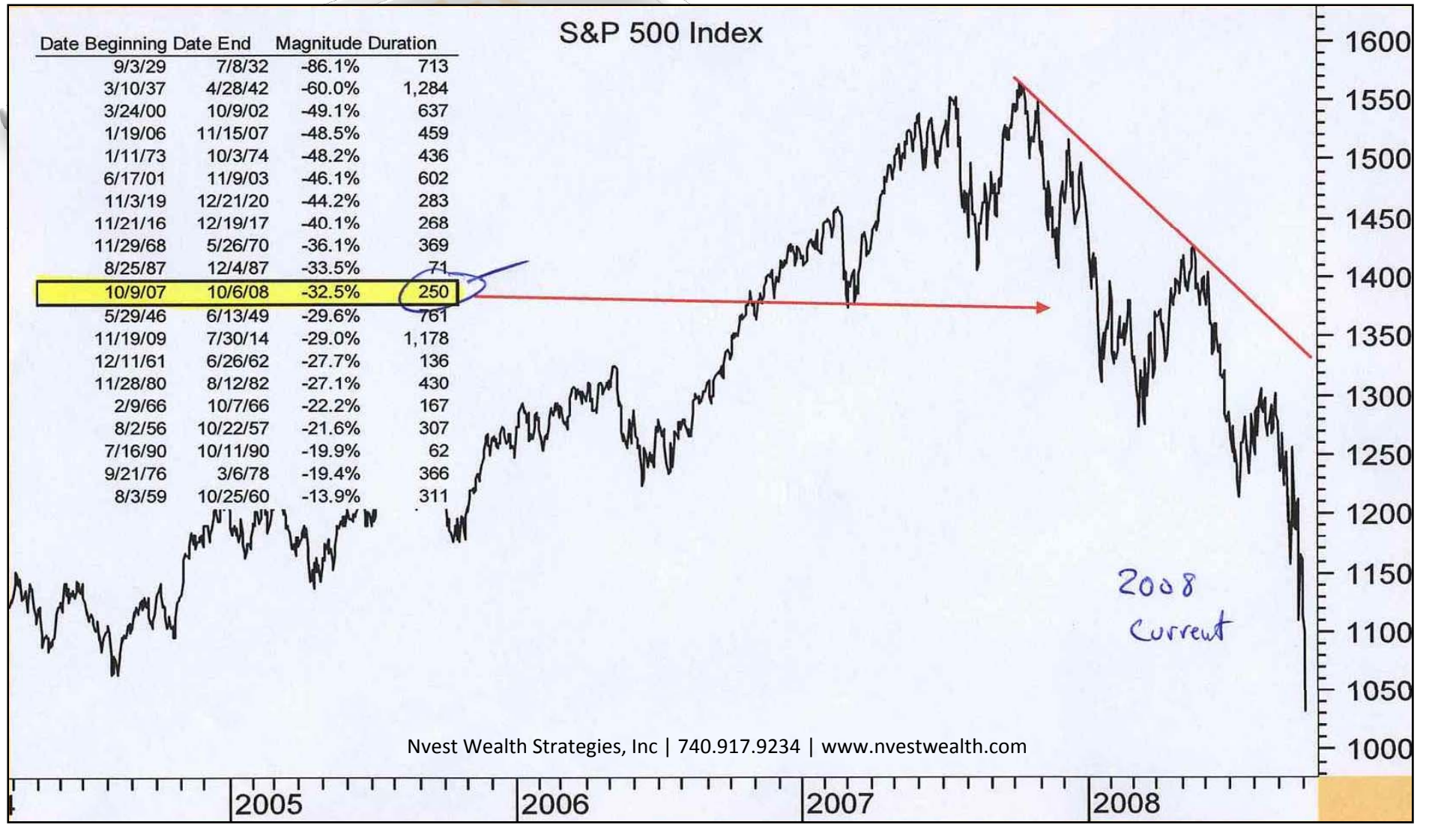
* S&P 90 stock composite before 2/1957

10/14/2008

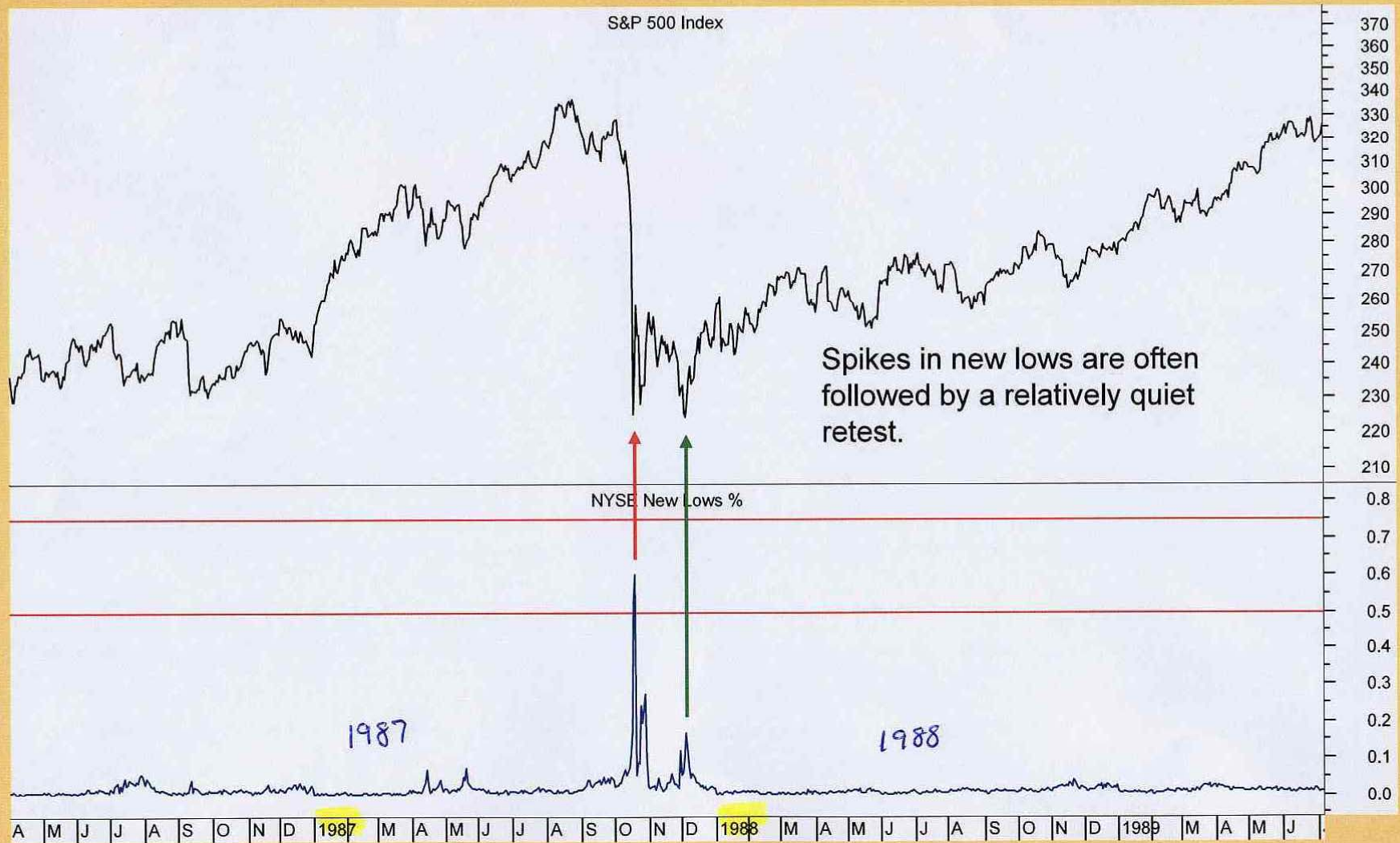
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Friday's Low was a BANG, Now do we need a Whimper?



Internal vs. External Low or “The Bang vs. Whimper”

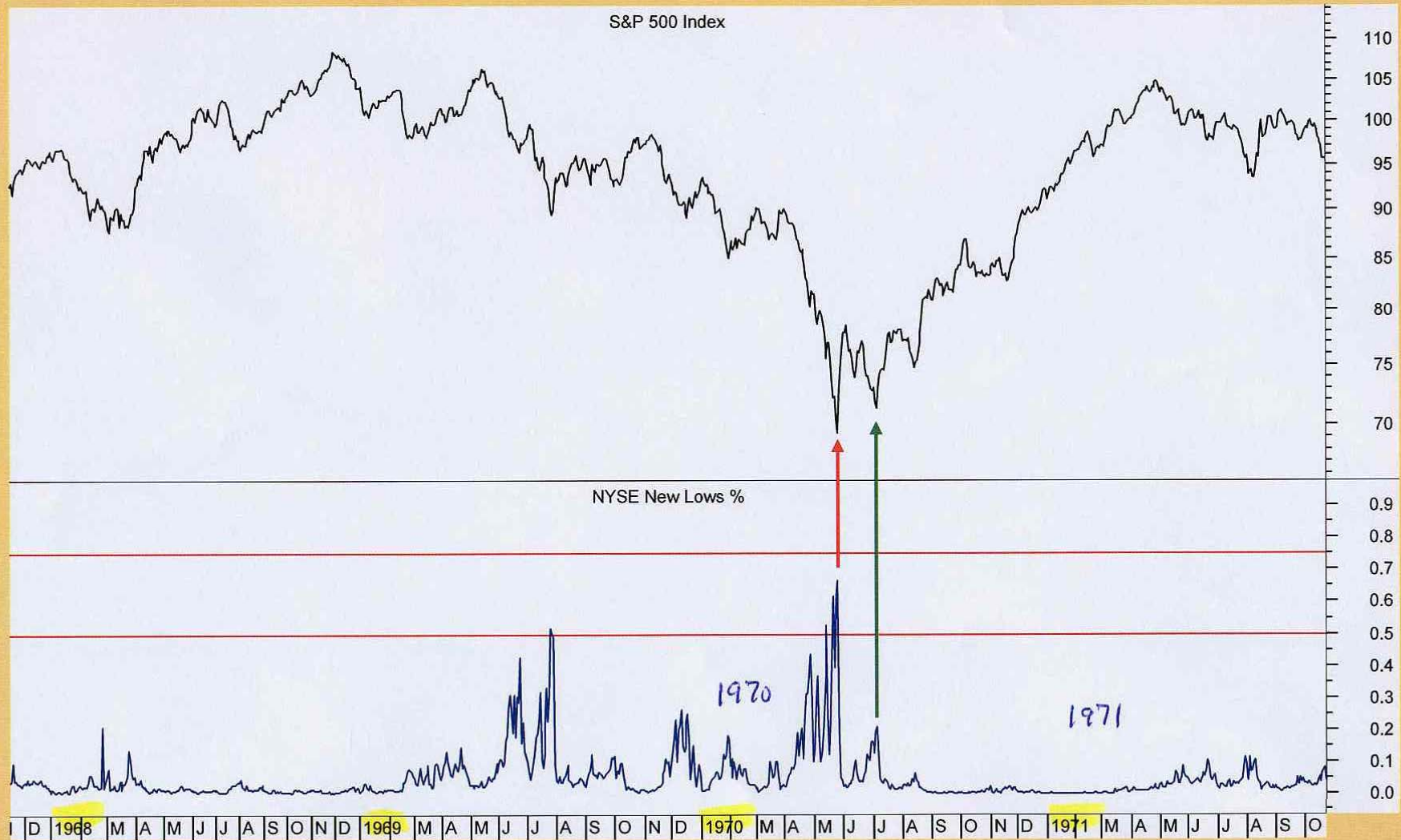


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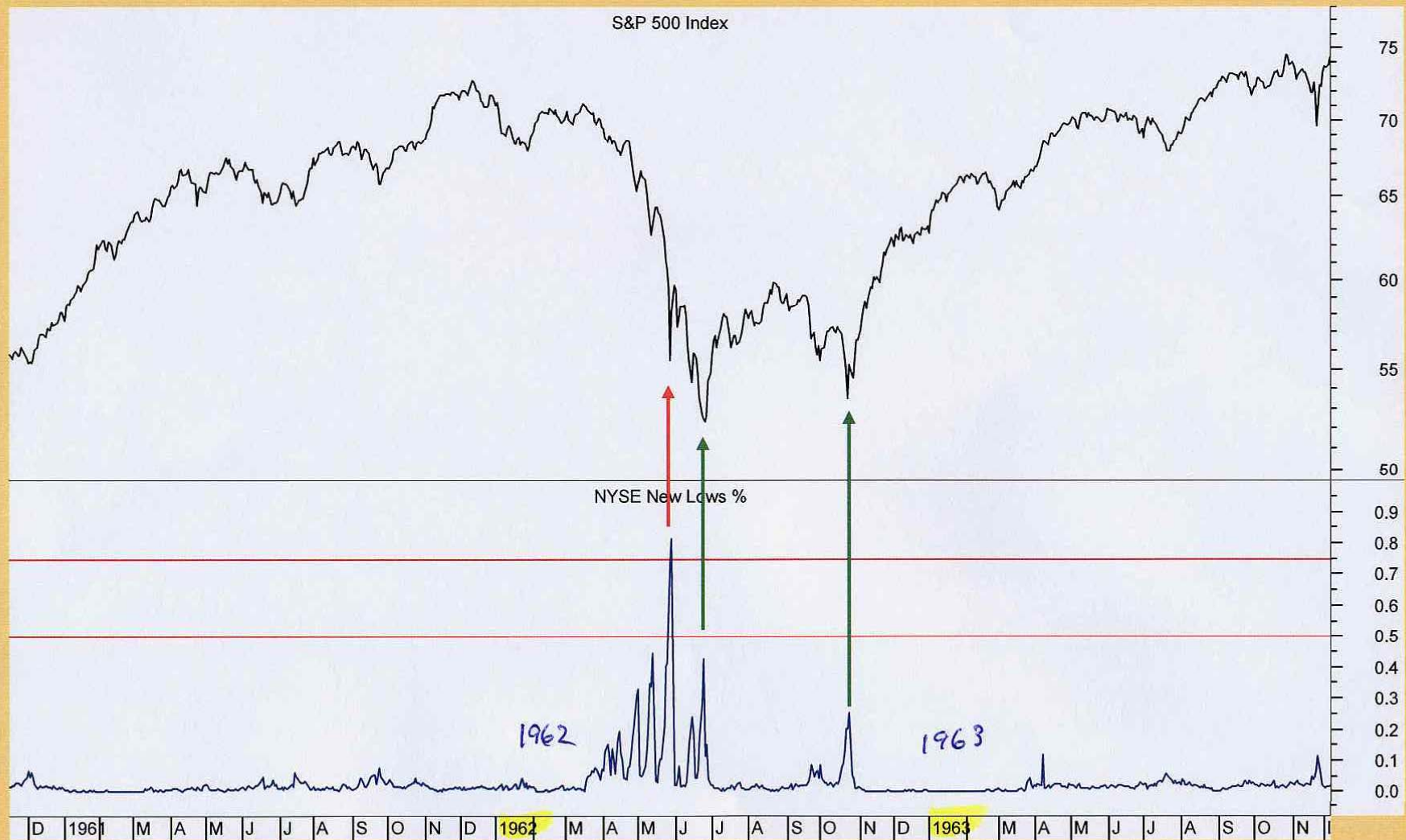
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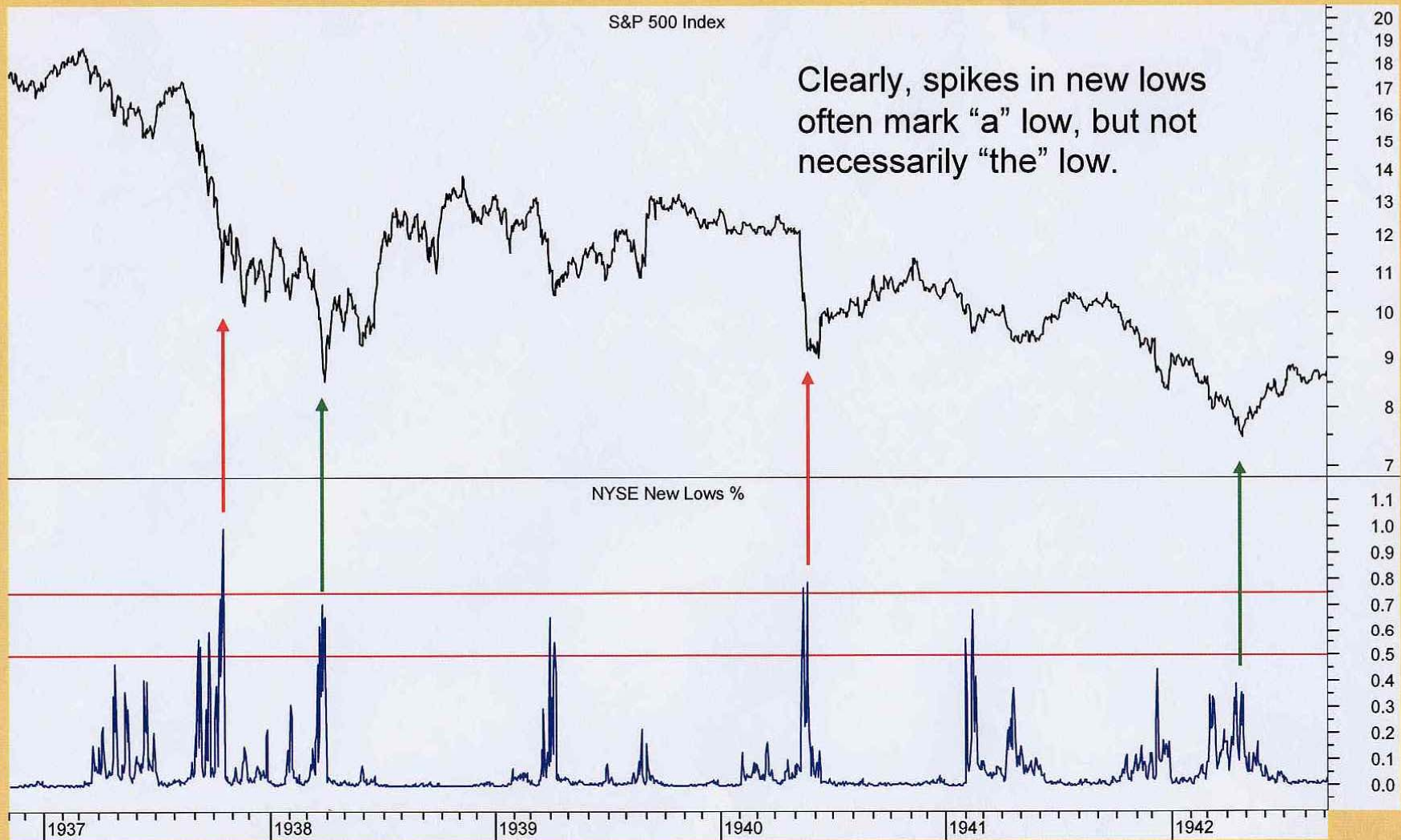
Retest six-weeks post low



Classic Bullish Divergence



Late '30s Were a Series of Retests

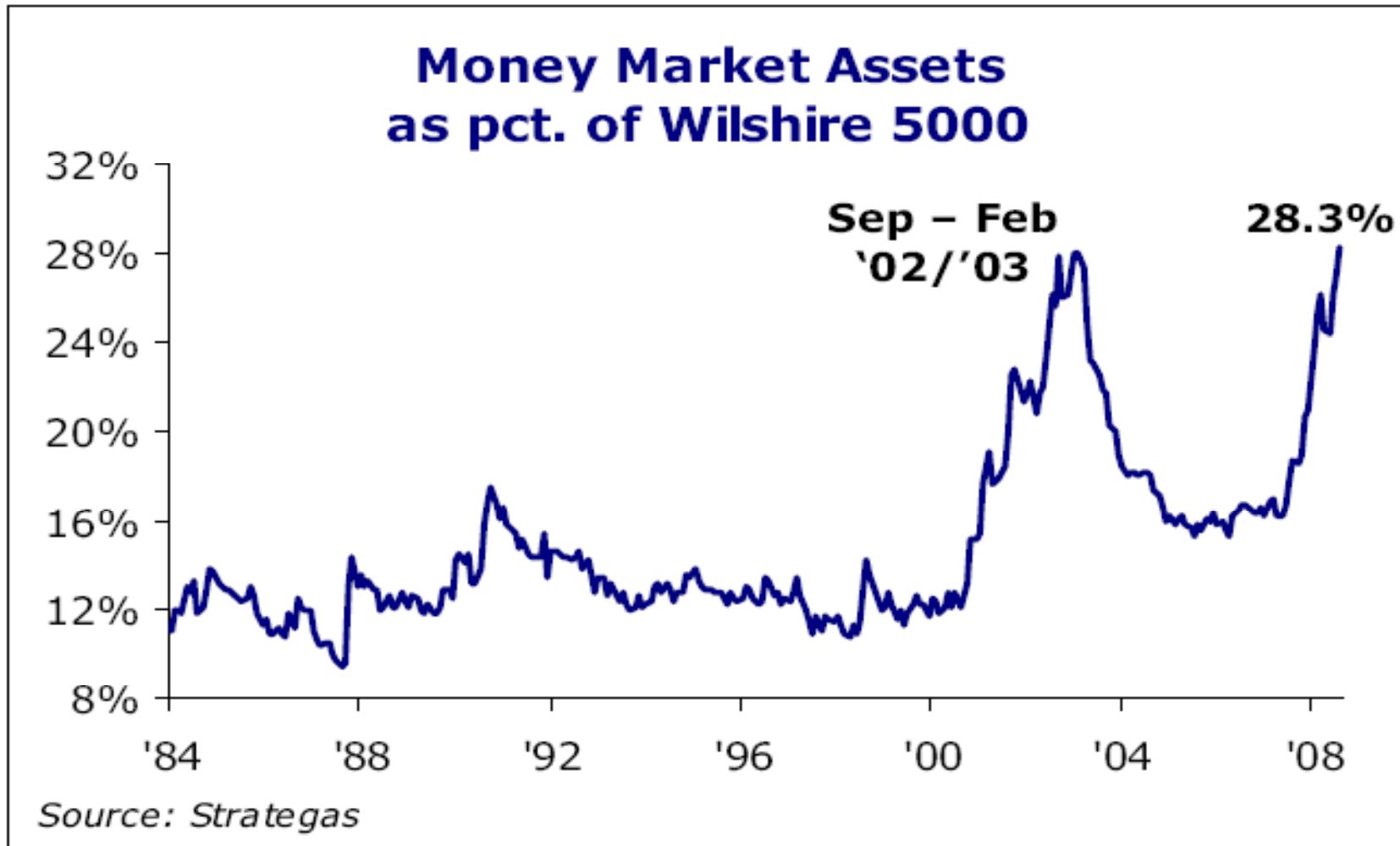


We Think the Stock Recovery Will Take Time Like A “U”



What we are doing in portfolios...

Lots of Cash Waiting to be Invested



Money Market Assets as a percentage of total US market capitalization have surpassed extreme levels seen before 2002 Bull Market start.

Despite US-led Financial Crisis...

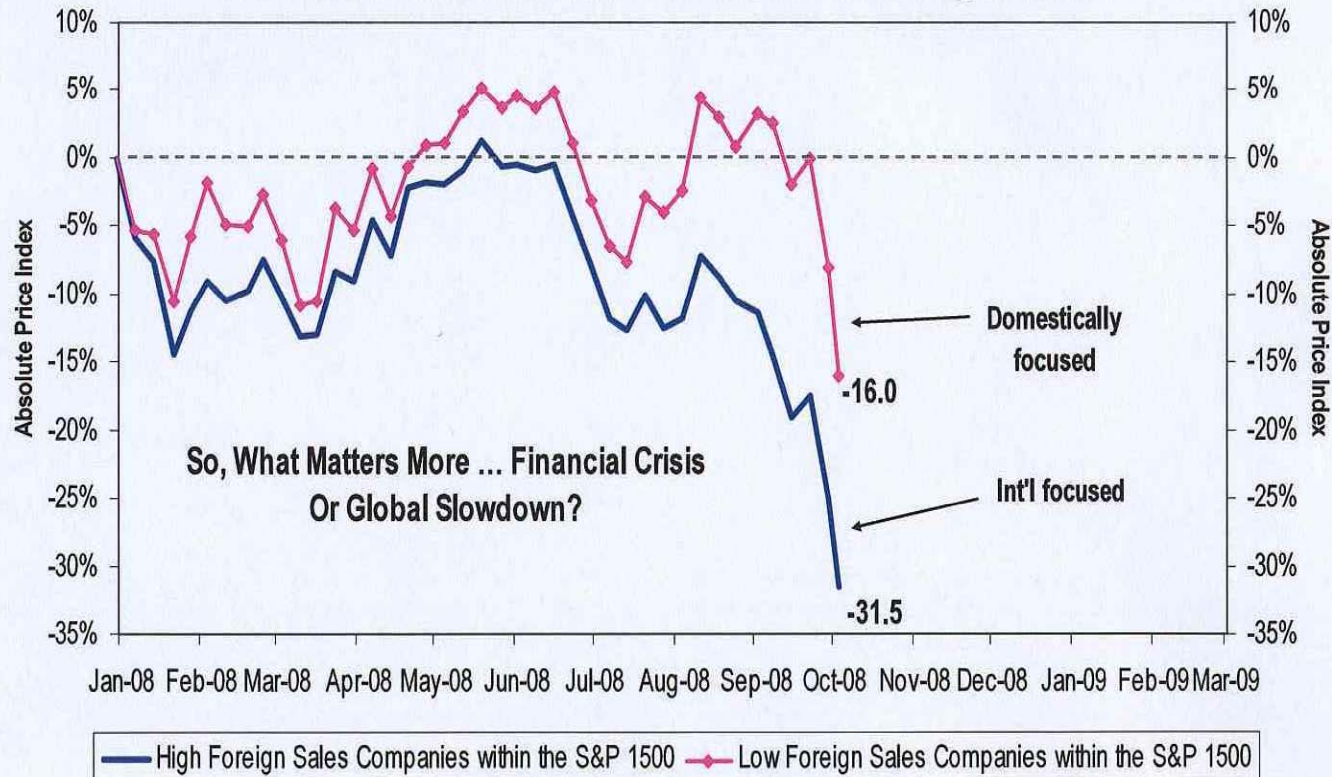


US still seen as safest home for money during international crisis.

Q: What Has Changed Since The End Of Q2?

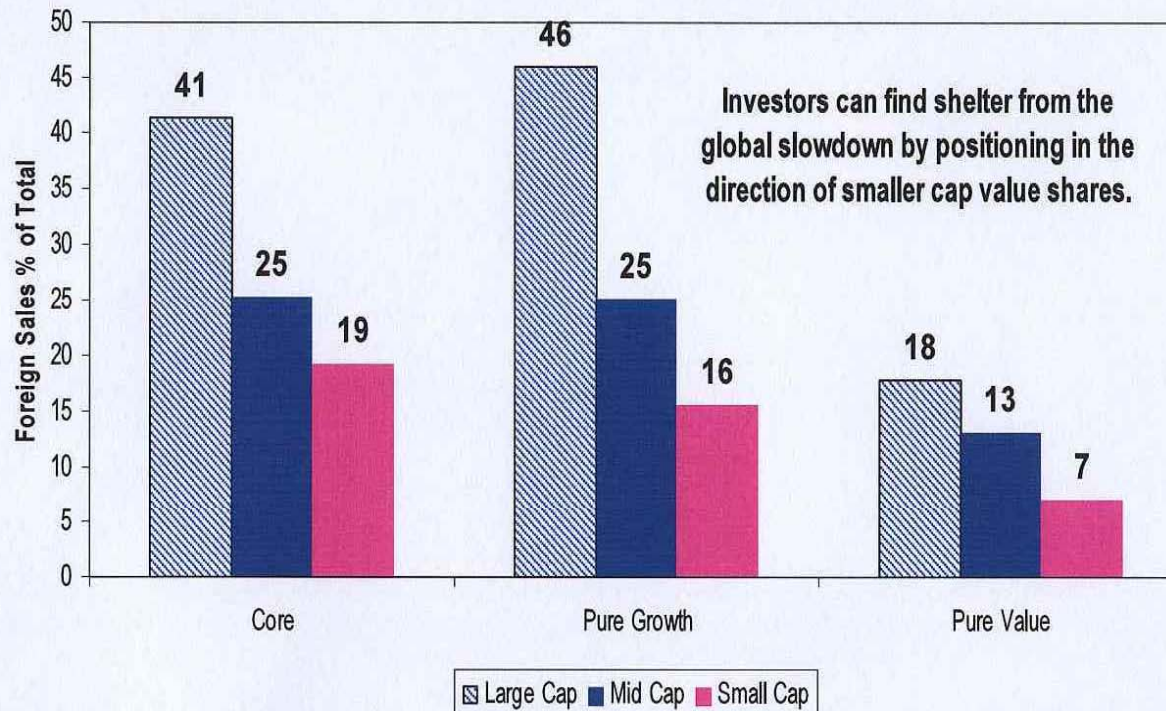
A: The International Component Of The S&P 500 Is The Weakest Segment

**S&P 500 Performance Likely To Remain Polarized
Between Domestic and International Components**



Foreign vs. Domestic Arbitrage
It Permeates All Segments Of The Market!

Positioning For The Global Slowdown Across Size and Style



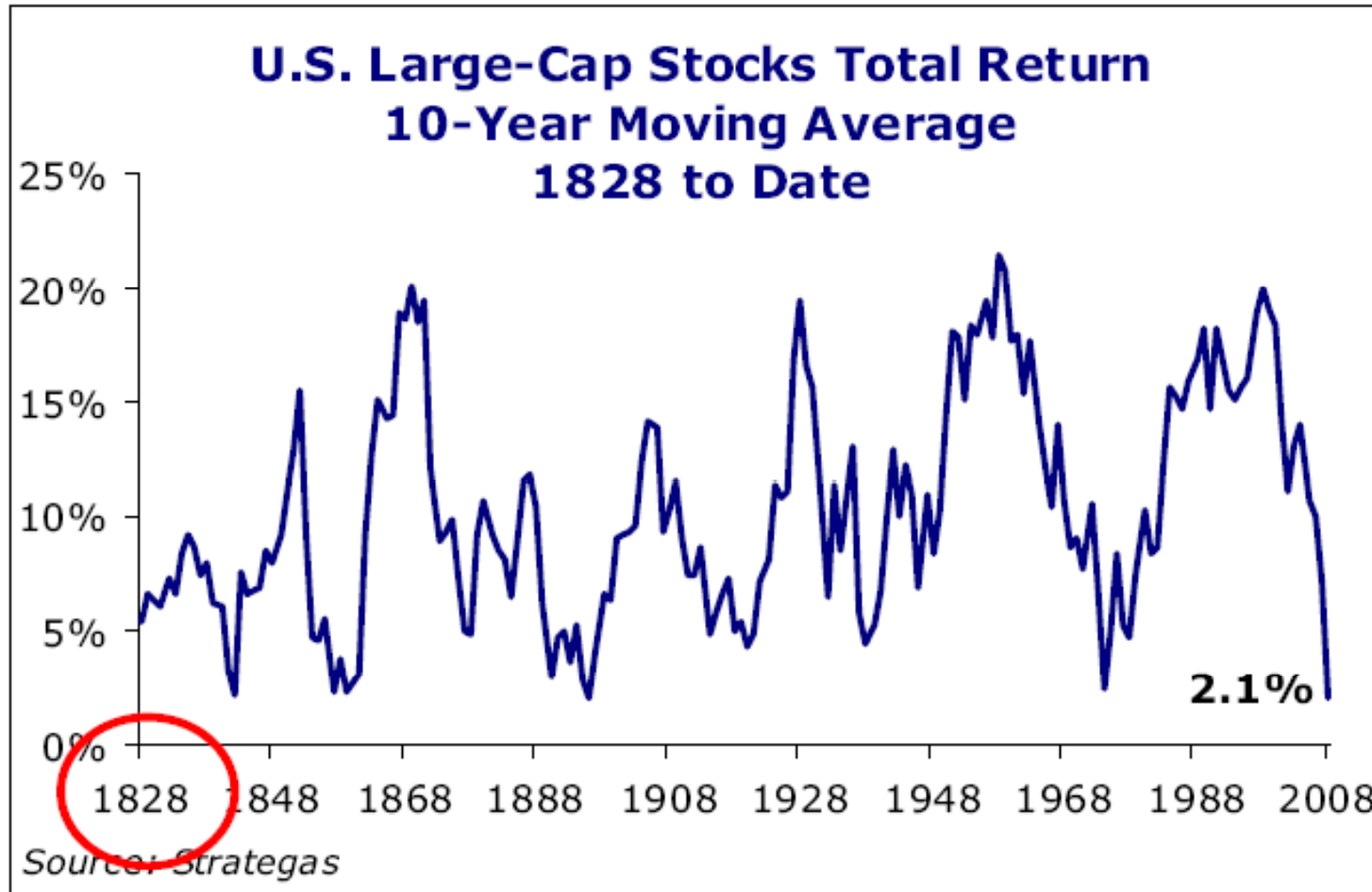
Investors can find shelter from the global slowdown by positioning in the direction of smaller cap value shares.

Large cap indices have the highest level of foreign exposure ...

... within the style arena, Growth has a greater dependency on international economies.

Source: ISI Portfolio Strategy.

Large Caps Look Historically Cheap Despite International Exposure

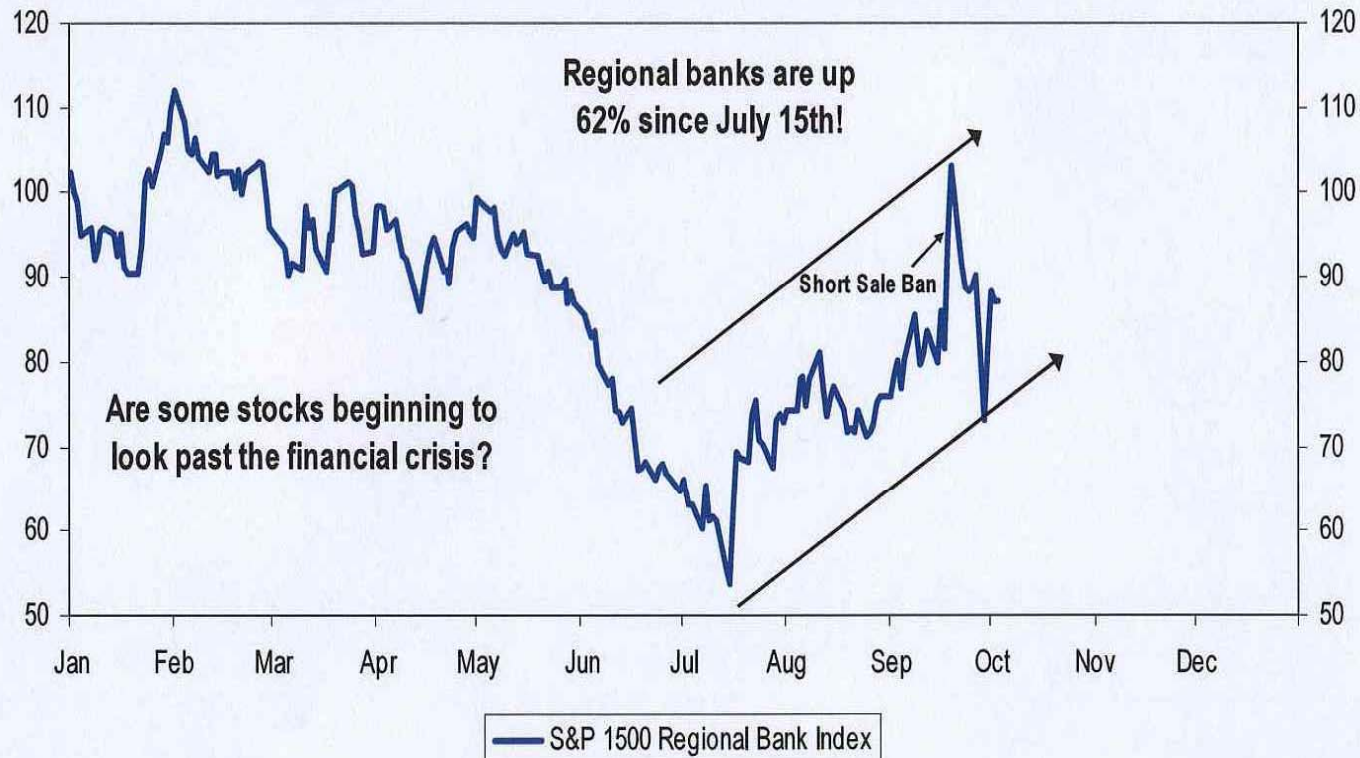


**The current 10-year period ranks among the
worst for US large-cap stock returns.**

Q: What Has Changed Since The End Of Q2?

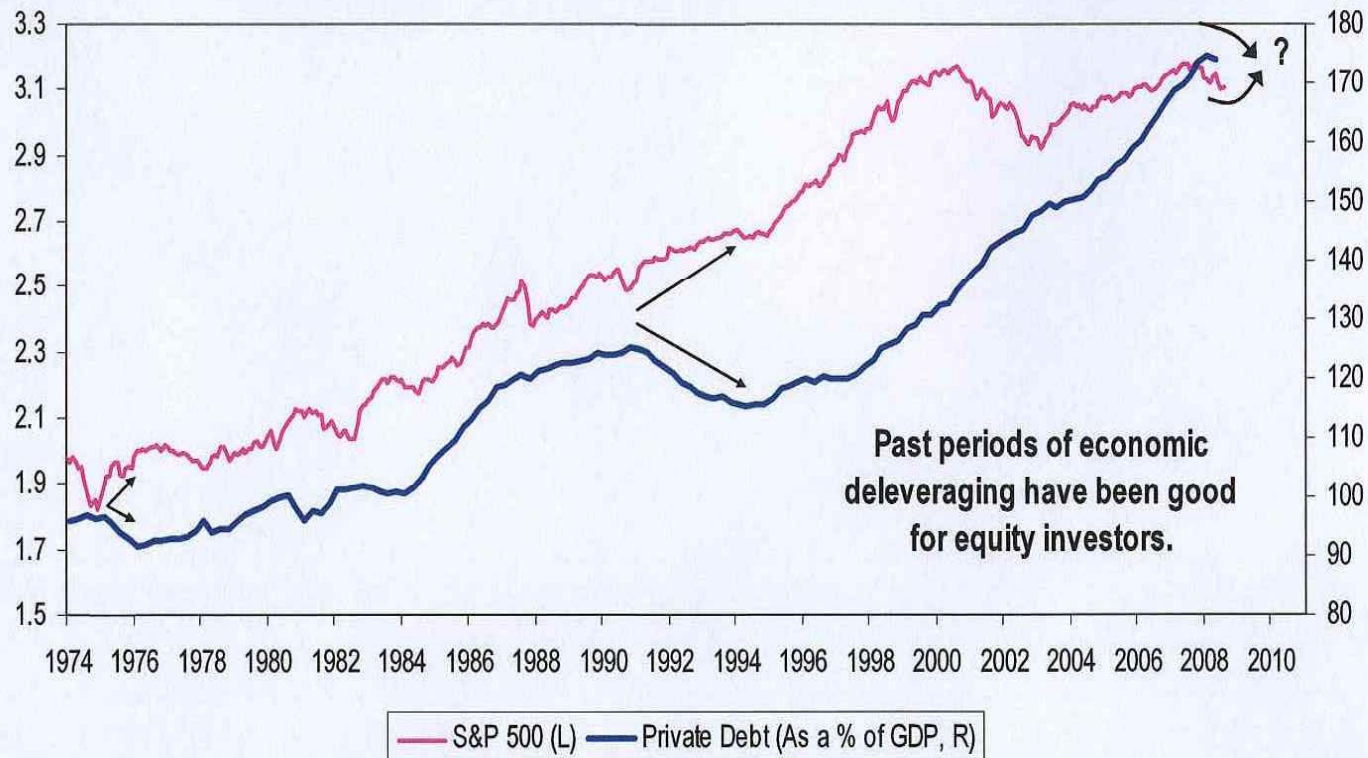
A: Rate-Sensitive Equities Have Begun To Respond To Fed Policy

Financial Crisis Old News For Bank Stocks?



Three Key Byproducts Of The U.S. Financial Crisis *#3) The Beginning Of A Deleveraging Cycle*

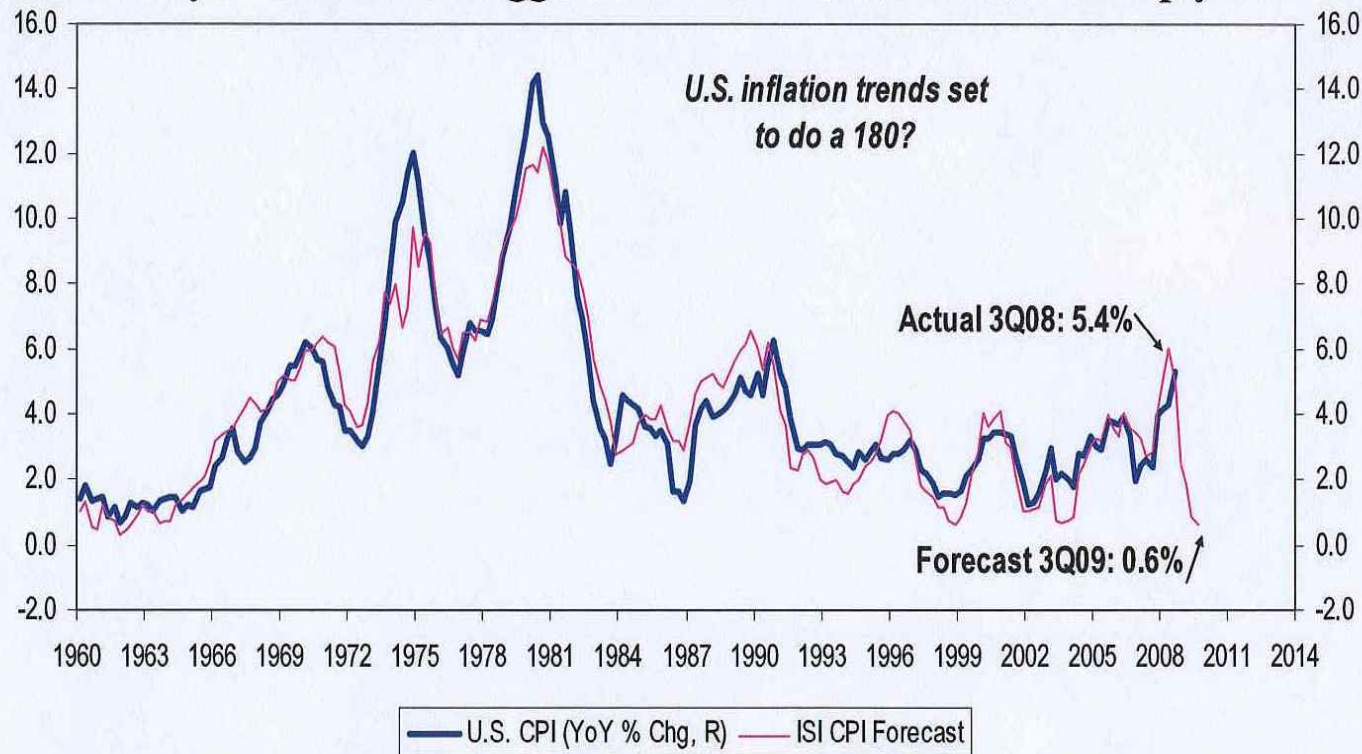
The Market Has Proven Resilient In Past Deleveraging Cycles



Three Key Byproducts Of The U.S. Financial Crisis

#2) A 180° Turn In Inflation Trends

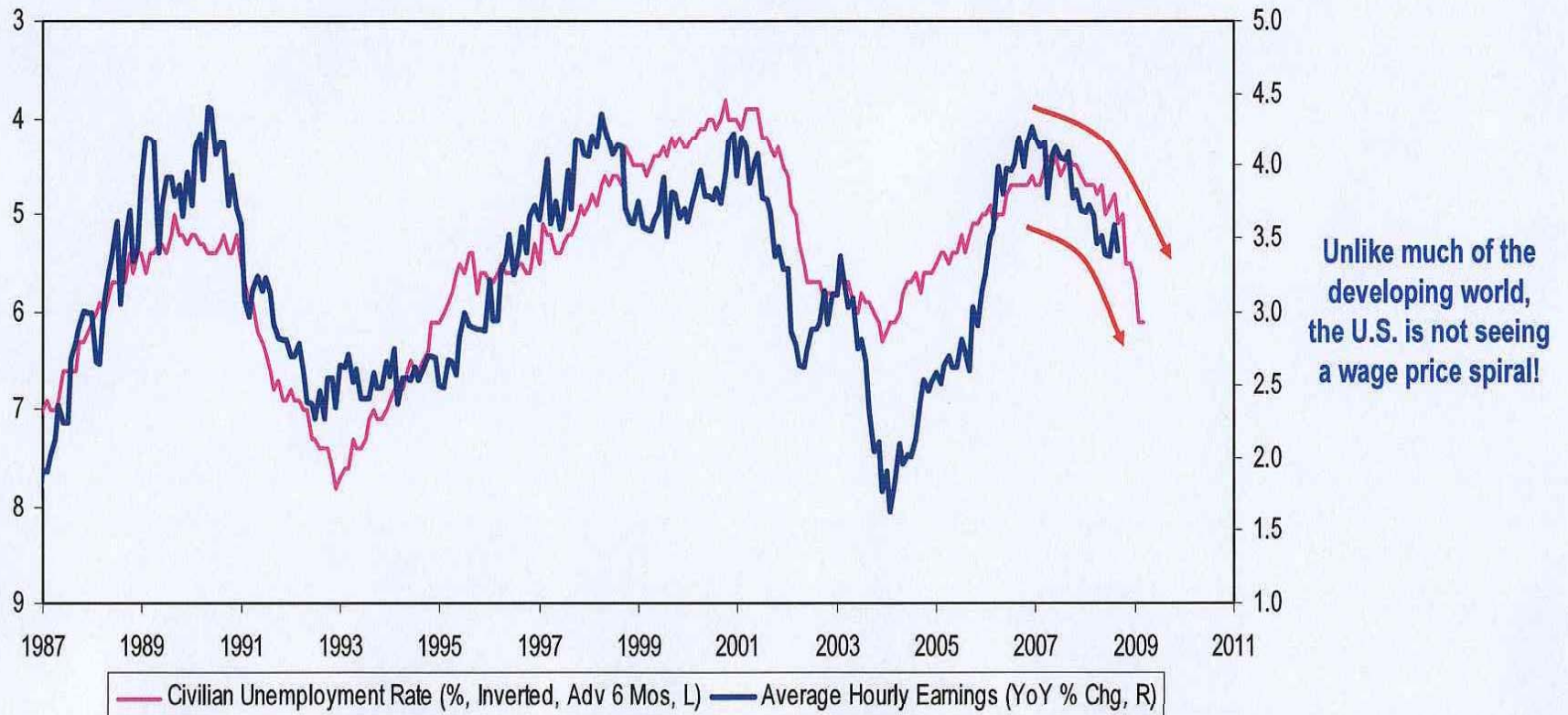
Ed & Nancy's CPI Model Suggests That CPI Is Set To Slow Sharply In 2009



Three Key Byproducts Of The U.S. Financial Crisis

#2) A 180° Turn In Inflation Trends

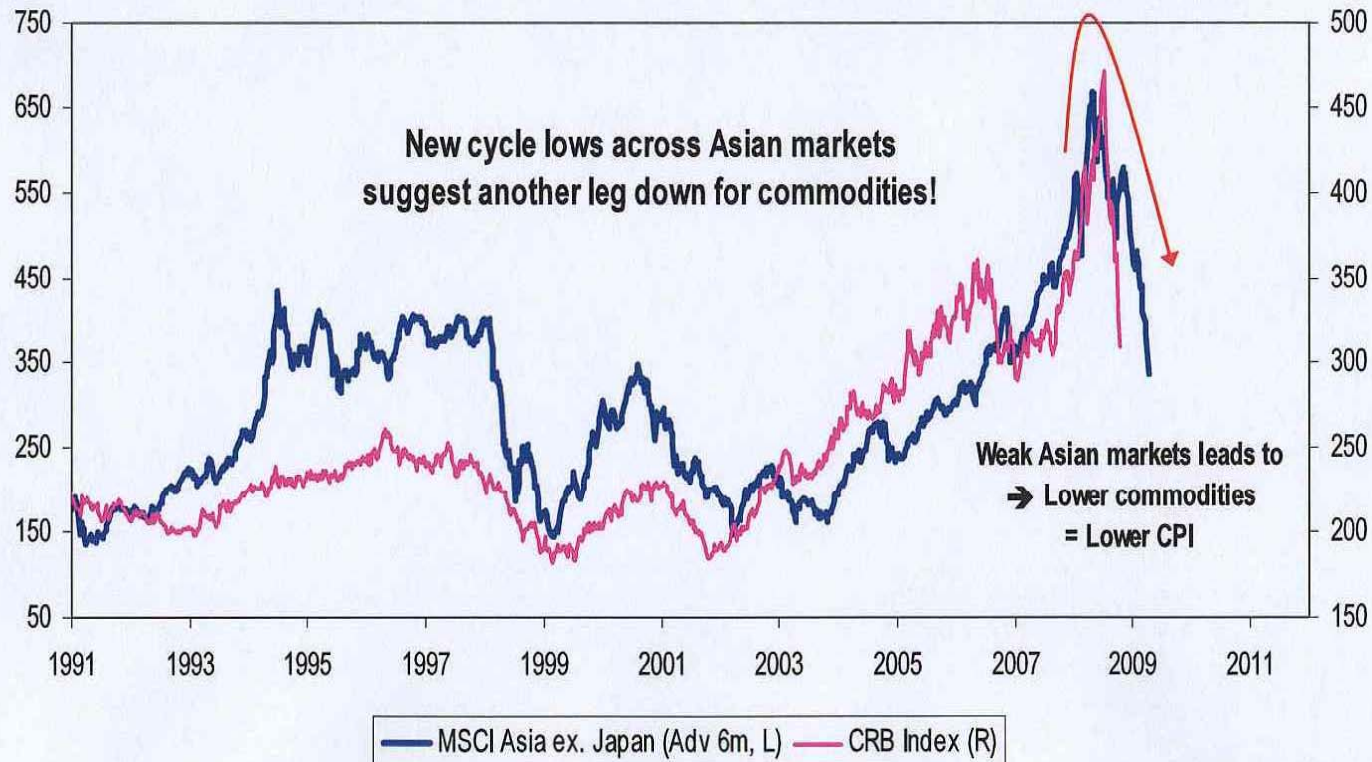
Tame Wage Growth Is Restraining Domestic Inflationary Pressures



Three Key Byproducts Of The U.S. Financial Crisis

#2) A 180° Turn In Inflation Trends

A Slowdown In The Developing World Would Reduce U.S. Inflation



Six Keys to Improved Outlook

1. Oil continues to decline: \$147 to \$80 (-43%)
2. Inflation slows significantly (may be dead)
3. ECB needs to ease a lot more
4. Mortgage rates need to decline further
5. LIBOR + short lending rates decline – roadblock
6. Continued coordinated Policy Response

Important to Recall the Basics

- **We've been through difficult times before. Think back to 2000.**
- **Return to the basics:**
 - Live within your means
 - If retired, maintain or reduce distributions
 - Reduce your debt
 - Keep saving – AND investing
 - Buckets of time – how many years of cash and bonds is in the portfolio
 - Asset Flexibility
- **Stay invested for the long term.**

What Else do We Expect...

Investment Tips for 2008-09

- **Watch for these business consolidations:**

1. Hale Business Systems + Mary Kay Cosmetics + Fuller Brush + W.R. Grace =
2. 3M + Goodyear =
3. Zippo Manufacturing + Audi Motors + Defasco + Dakota Mining =
4. FedEx + UPS =
5. Fairchild Electronics + Honeywell Computers =
6. Grey Poupon + Docker (Pants) =
7. Victoria's Secret + Smith & Wesson =



Can You Weather the Storm???

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Questions???

- What was the reason for Monday's (10/13/08) bounce?
- With all the government policy response, how much is an increasing deficit by our government increasing the risk of our financial system / economy?
- How do the various entitlement programs (social security, medicare, etc.) get paid for and what is that effect on the recovery?