A Little Perspective

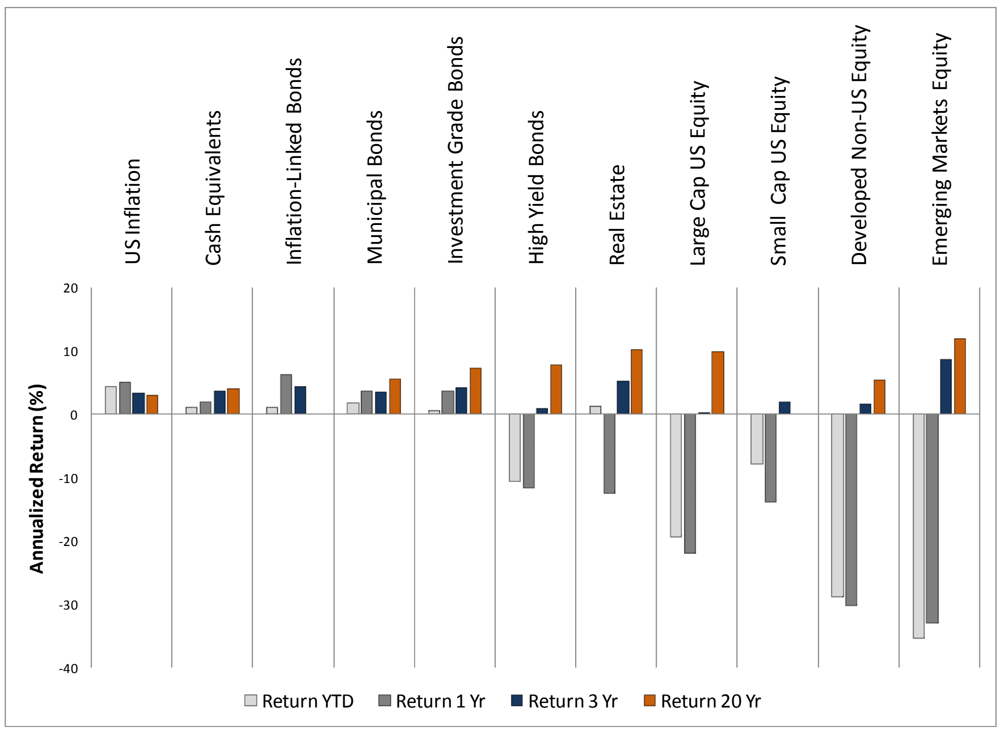
Stembrook Investment Commentary – October 16, 2008

Dear Valued Client,

The recent months have presented a very challenging time for investors in equities, among other asset classes. Recession seems to be a foregone conclusion. Government efforts to address the current turmoil in the financial markets will almost certainly result in a changing regulatory landscape. Policies designed to stabilize the global economy seem to be showing glimmers of progress and perhaps the worst is behind us, but in all likelihood there will be more rough going ahead. With all of these uncertainties clouding our view, it is instructive to take a detached look at the data and to remind ourselves why we've chosen to make stocks a significant part of our long-term investment plans.

What's happening? Assessing the Numbers. Financial markets around the world have sold off dramatically in the past twelve months. **Chart 1** provides a view of financial market returns grouped by the asset classes we use in developing your *Stembrook Strategic Investment Plan*. The asset classes are ranked from left to right by their risk, or volatility. Those to the left have done a relatively good job of preserving capital, while those to the right have been hard hit by the recent global financial shocks.

Chart 1 – Global Market Returns as of 9/30/08



Source: Thomson Financial, Stembrook Research.

Indices: Consumer Price Index - US, U.S. 30-Day Treasury Bills, Citigroup Inflation-Linked Index, Lehman Brothers Munis 5-Yr, Lehman Brothers Aggregate Bond, Merrill Lynch U.S. High Yield Cash Pay, Dow Jones Wilshire REIT Index, S&P 500 Composite Total Return, S&P SmallCap 600 Total Return, MSCI EAFE Index, MSCI EM (Emerging Markets) Index

How Does This Time Measure Up?

The current downturn in stocks is severe. **Chart 2** groups annual returns of stocks since 1926 into clusters, with the lowest annual returns on the left, and the highest on the right. Viewed in this context, the US stock market's year-to-date return through October 9th was one of the worst in recent history, the third worst to be exact. So, *feeling* a sense of fear is a perfectly reasonable reaction. How to *act*, though, is another issue entirely.

Chart 2 – Annual Stock Returns by Year Since 1926, Grouped by Return

Annual Returns and (Years)

-50% to -40%	-40% to -30%	-30% to -20%	-20% to -10%	-10% to 0%	0% to 10%	10% to 20%	20% to 30%	30% to 40%	40% to 50%
						20% (1942)			
						20% (1944)			
					10% (1993)	19% (1972)			
					8% (1992)	19% (1949)		37% (1927)	
					7% (1978)	18% (1986)	29% (2003)	37% (1995)	
				-9% (2000)	7% (1956)	18% (1979)	29% (1998)	37% (1975)	
				-9% (1962)	6% (1984)	18% (1952)	27% (1961)	36% (1945)	
				-8% (1969)	6% (1947)	17% (1988)	26% (1943)	34% (1936)	
				-8% (1929)	6% (1948)	17% (1964)	24% (1951)	33% (1997)	
				-8% (1932)	5% (2007)	16% (2006)	24% (1967)	32% (1980)	
			-15% (1973)	-8% (1946)	5% (1987)	14% (1971)	24% (1976)	32% (1985)	
			-12% (2001)	-7% (1977)	5% (2005)	12% (1965)	23% (1996)	32% (1950)	54% (1933)
			-12% (1941)	-5% (1981)	4% (1970)	12% (1959)	23% (1963)	32% (1955)	53% (1954)
		-26% (1974)	-11% (1957)	-3% (1990)	1% (1994)	12% (1926)	23% (1983)	31% (1989)	48% (1935)
	-38% (2008)*	-25% (1930)	-10% (1966)	-1% (1934)	0% (1960)	11% (1968)	21% (1982)	31% (1938)	44% (1928)
-43% (1931)	-35% (1937)	-22% (2002)	-10% (1940)	-1% (1953)	0% (1939)	11% (2004)	21% (1999)	31% (1991)	43% (1958)

Range of Returns

*Through October 9, 2008

Source: Stocks (S&P 500) Ibbotson Associates, 1926 - 2007, Wall Street Journal 12/31/07 - 10/9/08; Stembrook Research

There is another overwhelming observation to be gleaned from this graphic. The vast majority (72 percent) of annual stock market returns are positive. This means that the odds are stacked in our favor, if we are willing to give stocks the time they require to deliver solid growth.

Why Stocks, Again?

When periods of financial stress and large declines in stock prices present themselves, it is sometimes difficult to keep the rationale for owning them in the front of our minds. The reason is simple. Over long periods of time, the volatility that stockholders endure is rewarded by significantly higher returns. This point is very easy to lose sight of in times of panic and fear.

Chart 3 summarizes the findings of a study that asks how two investors would have fared, had they invested one dollar in January of 1926 in very different asset classes. The two lower lines of the chart show what would have resulted from an investment in cash (think money market funds). The upper two lines show what would have resulted from an investment in stocks (think S&P 500). There are two lines for each asset class because one ignores inflation, while the other accounts for it. In the case of the investor who chose to make a "safe" investment in cash, his brokerage statement viewed on October 9th, 2008 would show a balance of roughly $21 dollars. That doesn't sound like large gain over almost 83 years, but it gets worse. In inflation adjusted dollars, he would have a mere $1.72 today. The brokerage statement of the investor who chose the "risky" investment in stocks would show a balance of roughly $2014. Adjusted for inflation, his gain would be equivalent to approximately $165. Stocks outpace cash by a large margin over long periods of time.

What About the Fundamentals?

One important point to remember is that when we purchase stocks we are buying the productive capacity of companies. Specifically, we are buying the future stream of cash flows derived from a company's profits. One of the most basic measures of the valuation of a company is the price-to-earnings or P/E ratio. This measure relates the net earnings or profits of a company to its current stock price. The higher the ratio, the more one is paying for a future stream of earnings, or the more expensive the stock. The inverse is also true. As of October 9th, ownership in the S&P 500 provides access to approximately \$50 to \$70[1] in annual earnings at a cost of approximately \$900. This results in a current P/E ratio somewhere in the ballpark of 13 to 18 times. The economy is slowing, and earnings have already fallen from a high of roughly \$90[2] per share since September of 2007, but unless these companies all disappear (something I wouldn't bet on), there will still be a stream of profits from which to derive a return on your investment in stocks. And, in the

Chart 3 – Why Do We Subject Ourselves to This Volatility

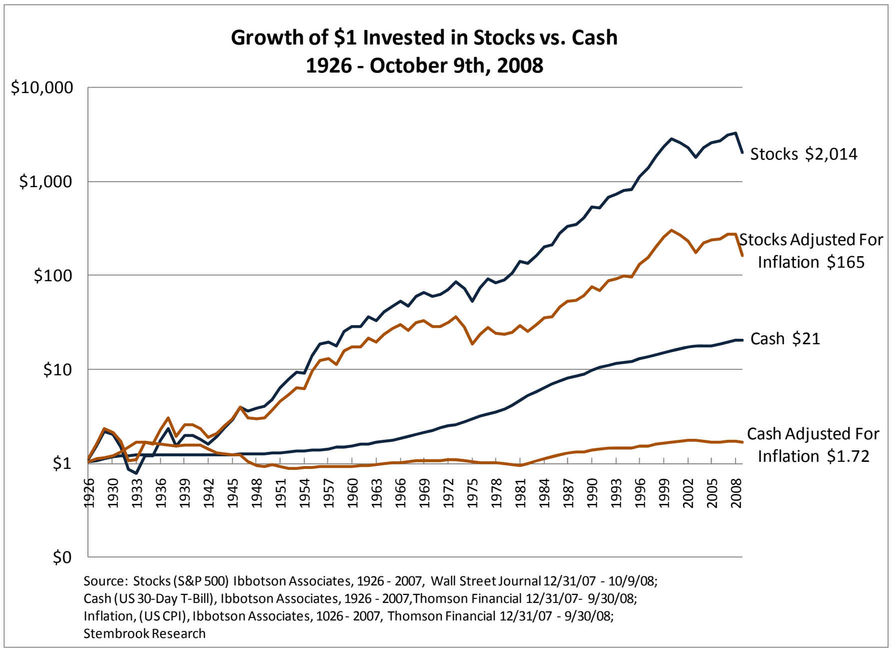
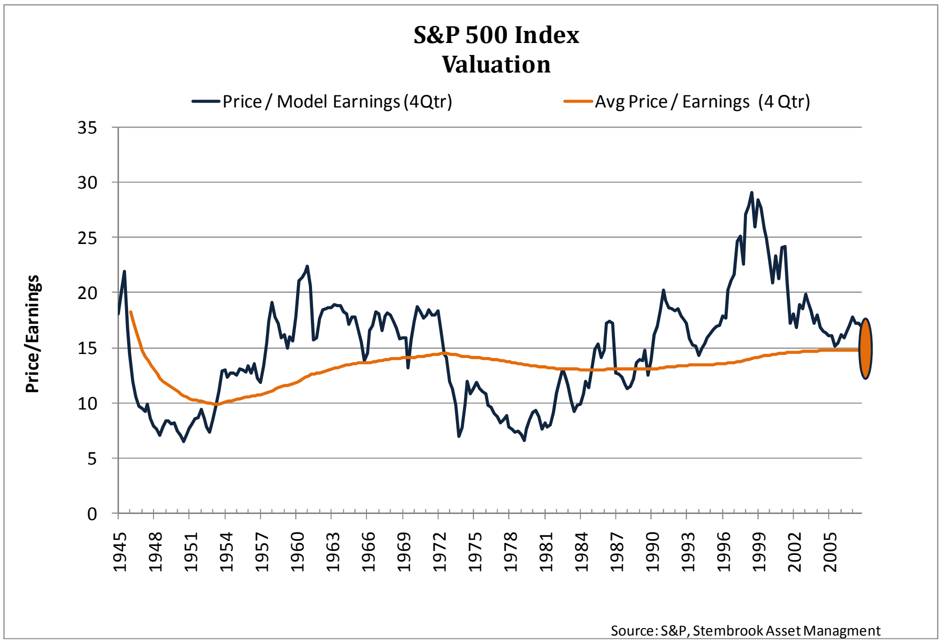


Chart 4 – Annual Stock Returns by Year Since 1926, Grouped by Return



[1] Trailing twelve month earnings. \$50 represents reported earnings; \$70 represents earnings adjusted for extraordinary items. Source: Standard & Poor's

[2] Trailing twelve month earnings adjusted for extraordinary items. Source: Standard & Poor's

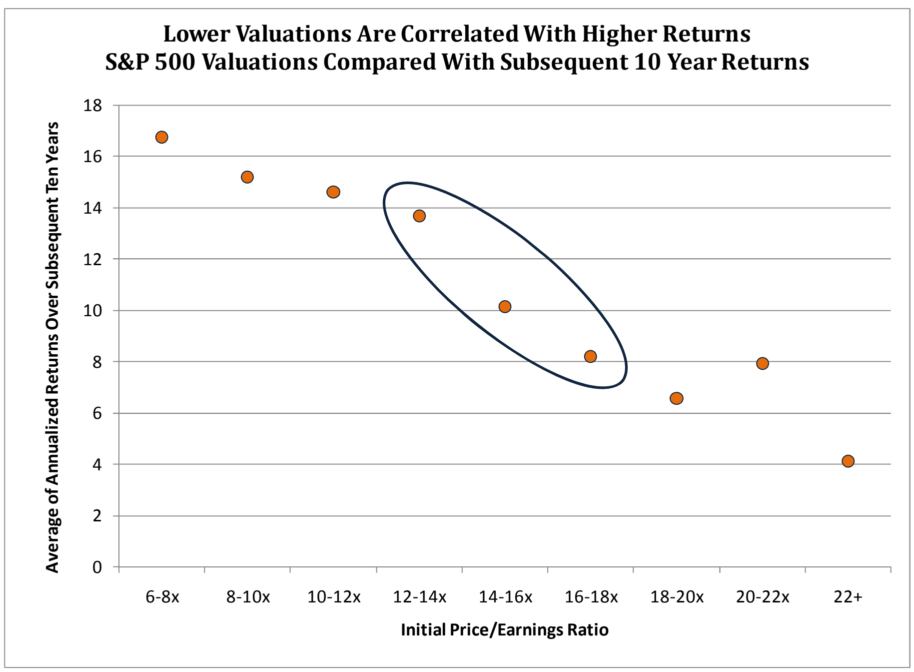
subsequent recovery, earnings will again rise. So, even though we should expect a short-term drop in corporate profits, stock prices have fallen significantly and are likely cheaper than they were a year ago.

To put this into perspective, I have presented in **Chart 4** the historical P/E ratio of the S&P 500 since 1945. Today, it seems that valuations are hovering somewhere around their historical average. Nowhere near the rich valuations seen towards the end of the technology driven bubble of the late 1990's, or as low as they were in the late 1940's and '70's

Why Is the P/E Ratio Relevant?

In the post World War II era, the valuation of stocks as measured by the P/E ratio has, on average, had an inverse relationship with future returns. In **Chart 5**, we see that after periods of very low P/E ratios, the following ten year returns were usually well above the historical average. For example, when P/E ratios were between 6 and 8 times, the return on the stock market for the subsequent ten years was almost 17 percent per year. At the other end of the spectrum, when P/E's were higher than 22 times, the average returns for the next ten years were just over 4 percent per year. Our current estimate of a P/E ratio between 13 and 18 times is circled in the chart, and the average ten year return following such levels has been between 8 percent and 14 percent. This is not a guarantee that these returns will repeat, but it does give a sense for where we are on the continuum.

Chart 5 – Stock Valuations vs. Subsequent Returns 1946 – October 2008



Source: S&P, Stembrook Asset Management

What is Stembrook Doing Now?

Since my last letter, Stembrook has been taking a number of actions to position portfolios for the current uncertainty and the future recovery. Stembrook's efforts center on two major goals. 1.) Keep liquidity assets safe, and 2.) Keep investment capital at work. Long before this financial crisis unfolded, we set a strategy in motion. That strategy was carefully outlined in your *Stembrook Strategic Investment Plan*. In that plan we made a clear distinction between the money you may need to live on, or are reserving for a specified use in the coming years, and the assets allocated for long-term investment. We can call the first group liquidity assets and the second investment capital.

Regarding your liquidity assets, Stembrook has diversified across individual securities through funds, and in some cases across different funds or Certificates of Deposit to minimize risk while maintaining reasonable yields. If you have specific questions about the safety of these assets please do not hesitate to call.

Regarding your investment capital, one of the key ingredients to executing your plan is maintaining your investments in times of stress, and to specifically add to asset classes that have recently underperformed. In the past weeks and months, we have been adding to equity positions with a particular focus on small cap and emerging market equities, where our allocations have been exceptionally low in recent times. We will also be keeping an eye on opportunities to add to other asset classes when they become more attractive candidates for purchase.

One of the greatest challenges for investors right now is keeping up with the almost daily flow of information from legislators, policymakers and leaders around the world as they address the current financial turmoil. I propose that limiting your exposure to the constant barrage of media coverage is highly advisable. Generally speaking, I am confident in the intellect and wisdom of our Treasury and Federal Reserve officials and am encouraged by the recent global coordination to address the issues at hand.

With the points outlined above as backdrop, Stembrook will continue to manage your assets and mine in line with our plans and with a focus on long-term growth. Please remember that our work hinges on our understanding of your financial situation and long-term goals. If you believe that your financial situation has changed significantly, please contact us to schedule a time to review your plan.

As always, I thank you for your continued confidence in Stembrook, and I look forward to speaking with you soon.

Sincerely,

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Important note regarding Stembrook's capital market expectations.
The capital market expectations developed by Stembrook Asset Management are estimates of both a central tendency of asset class behavior and a probable range of asset class behavior over a long-term horizon. These estimates are one of many inputs used in the portfolio construction process, and should not be used independently. These expectations should not be construed as the returns that will be achieved, but merely those that may be achieved if certain assumptions hold true. Also note that each client's portfolio may differ given specific goals and constraints applied to the portfolio construction process.

Additional information is available upon request.