

Quarterly Investment Commentary

First Quarter 2008

During the first quarter of 2008, which included one of the worst January performances on record, the S&P fell 9.4% and the NASDAQ fell 14.07%. In fact, from its high in October to its low in March, the broad US stock market has fallen over 18%. As you will see later in the commentary, this level of loss is normal for a bear market environment. Volatility has also increased, with indices such as the Nasdaq up or down over 3.5% in one day. However, after having been solidly in bear market territory for the past six months, indications are that we're in a bottoming-out phase. Our goal during these situations is to minimize losses and position ourselves for continued long term gains. We feel we've been successful with both goals, and have begun looking forward towards the next bull market run.

Q1 S&P 500 -9.4%

Stocks

As mentioned, stocks fell precipitously in Q1. Declines occurred in almost every equity asset class. The MCSI world index fell 14.5%, the Morningstar broad US market index fell 9.48%, and all Morningstar style categories (large/mid/small & value/growth) experienced significant slides. Going hand in hand with this fall has been a marked fall in investor confidence, reaching a level typically not seen except near the bottoms of market cycles.

The market and investor pessimism was kicked off by the fall of the housing market and exacerbated by the corresponding burst of the credit bubble. Liquidity has become significantly curtailed due to a lack of confidence among financial firms as to the true valuation of the assets against which they lend and borrow. This deflating of the credit markets has caused much trouble in the financial sectors capped by the near failure of Bear Sterns, a well-established investment bank that has been around for more than 80 years. In response to these "crises", the Fed has taken very aggressive action by lowering interest rates, supporting investment banks, and trying to systematically remove the obstacles to lending. While in some ways this Fed action has been unprecedented, it's interesting to note that financial sector "crises" have occurred during every recession since 1970.

Many of you will remember vividly the S&L crisis of the early 1990's. In many respects, our current economic situation resembles that of 1990-91 when there was a severe downturn in commercial real estate (some called it a real estate depression), war in the Middle East, a sharp spike in oil prices, and the S&L crisis. Overall, the 1990-91 recession lasted eight months, two months shorter than the average post WWII recession of 10 months. In recessions prior to 1990-91 we also saw the bottoming of the economy coincide with the failure of several large banks.

When viewed in context, the current economic slowdown and financial crisis are significant but certainly not unprecedented as compared to past economic recessions. Since stock prices are a major leading indicator of economic performance, we anticipate that the stock market will begin its correction prior to the economy correcting. In fact, it's often when economic news is at its worst that stocks begin their ascent.

At this point we regard stocks broadly as having good values. If they fall further, they could become great values. Our current view is that stocks are likely to go up in the mid-term, but only in retrospect can we determine when the lowest point had been reached. We are staying with our current "neutral" stock exposure, but if markets continue to fall we will likely start to overweight stocks.

Bonds

Offsetting stock declines, Treasury bonds have increased a lot in price over the last six months, due to the typical "flight to quality" when investors perceive high risk and uncertainty with equities. The fact that we have kept our clients' portfolios well-balanced between stocks and bonds is one factor in having reduced our clients' losses during this period. However, we believe that Treasuries are at this point very expensive.

Other bond sectors, however, look considerably more attractive. In fact, mortgage-backed bonds issued by federal agencies such as GNMA and FNMA, investment-grade corporate bonds, and tax-exempt bonds currently offer very compelling yields as compared to Treasuries. The problem is that Treasury yields are so low that the appeal of other bond sectors is mostly relative rather than absolute. Still, 20-year tax-exempt muni bonds are yielding as much as 5% (which could equate to as much as 8% for a taxable bond) and we additionally expect to get good capital appreciation from them. Also for tax-exempt investors, agency mortgage-backed bond yields are well into the 5% range and are federal tax-free. (Recently, PIMCO Total Return, our core bond holding, had about 60% of its portfolio in agency mortgage-backed securities.) So we are seeing some very good bond opportunities that will likely provide outstanding bond returns in the near term.

High-yield bonds, on the other hand, are cheap but still carry too much risk in the current market environment. Yields are now over 11% and will probably go higher if the recession is average or worse. Dr. Edward Altman of the NYU Stern School of Business, and a prominent high-yield market researcher, believes a slew of lowly rated bonds issued earlier in this decade could result in high-yield default rates as high as 16% if we experience a recession comparable to 1990. With the passage of time, when the coming spike in defaults is nearer to its peak, expected returns are likely to be compelling. We'll be watching closely (and expect to be taking action at some point).

We'll continue to hold developing local markets bond funds, as we like the combination of a decent yield (over 6%) and potential for more currency appreciation. We believe the case remains compelling for dollar depreciation against many emerging market currencies and Asian currencies in particular. The case is supported by trade surpluses that many of those countries have with the U.S., emerging markets' generally stronger economic growth, their (generally) sizable currency reserves, and the likelihood that many of these countries (led by China) will find it increasingly in their best interest to allow their currencies to appreciate in order to reduce inflation pressures in their domestic economies. Importantly, our exposure to developing market currencies also provides our portfolios with some inflation hedge, as a depreciating dollar is associated with rising pressure on the prices of commodities and imports.

REIT's

At their low point earlier this year, REITs were down well over 30% from their 2007 peak (this takes into account dividends). However, prior to this point REITs were overvalued. At present we view REITs as fairly valued, but with credit markets tight and momentum not in their favor, we view

risk on the downside. While in the near term it seems likely that prices will decline in the property market, the public REIT market is already priced to take into account significant price declines. We'll stay underweight to REIT's but will be looking for opportunities to move the position closer to neutral.

Commodities

Like bonds, commodities have helped buoy client portfolios. In addition to providing diversification, we have viewed commodities as a good tactical holding because of increased worldwide demand and limited supply. Despite their current run up in price, and the speculative overbidding of oil, we still see good mid to long term appreciation potential. We will continue with our current weighting of commodities for both diversification and appreciation potential.

Conclusion

While markets across the world have dropped significantly from their highs last year, we've been able to reduce the downside in client accounts by diversification and tactical asset allocation. Since stock prices are a leading indicator of economic performance, stocks almost always start to rebound months before the end of a recession. If we are already in a recession, stocks will probably begin to rebound later this year, if they have not already bottomed.

Crises and market volatility typically provide opportunities for educated investors, and this time is no different. While stocks seem relatively attractive at the moment, we are seeing the most compelling opportunities in the bond sector, particularly muni's and agency bonds. Conversely, Treasuries appear to be overpriced. In the stock markets, we still view large caps as more attractive than small caps, and we see growth-oriented stocks as being more underpriced than value-oriented stocks. While foreign and US stock markets may have similar return profiles, the differences in correlation between the two still offer risk reduction for those who are properly diversified. We'll continue with our positions in REIT's and commodities for the time being and will continue to monitor the markets for opportunities.

We appreciate your trust and are always available to discuss your concerns. As always, please feel free to contact us with any questions or comments.

Sincerely,

Peter, Jason, Bob, Tony, Lucy, Artie

The PWJohnson Wealth Management Team