

THIRD QUARTER 2008 IN REVIEW

What we are seeing today is the result of a risk-taking attitude that has persisted since the 1980s. Individuals and financial institutions have taken ever more aggressive risks leading to successive speculative bubbles in technology stocks, house prices, commodities, and exotic financial instruments. This was due in large part to the fact that once past the bad recessions of the 1970s, risk-taking generally paid off.

Poorly analyzed risks resulted in an ever rising amount of bad debts that finally overwhelmed the financial system. The consequence has been a huge loss of confidence and trust among investors, lenders, and borrowers. The priority today is to restore that confidence and trust and to stem the rising tide of bad loans.

Within the last three months, the government has put into place four basic firewalls to stop the hemorrhaging of losses in both confidence and in bad loans:

- ◆ “Reliquify” the credit and capital markets. That is, the government is trying to encourage lenders and investors to move their cash from short maturity government securities back into private sector securities.
- ◆ Increase the regulatory ability to act as a “circuit-breaker.” Actions include banning short-selling for unstable financial stocks and eliminating “mark-to-market” accounting regulations for securities (pending) held by financial institutions.
- ◆ Make available the wherewithal to allow financial institutions to improve their balance sheets. The new legislative act, TARP (Troubled Asset Relief Program), gives government agencies funds to buy bad loans from banks, who in turn are no longer at risk of these loans going from bad to worse. As Ben Bernanke, the Chairman of the Federal Reserve, recently stated, *“Purchasing impaired assets will create liquidity and promote price discovery in the markets for these assets, while reducing investor uncertainty about the current value and prospects of financial institutions. More generally, removing these assets from institutions’ balance sheets will help to restore confidence in our financial markets and enable banks and other institutions to raise capital and to expand credit to support economic growth.”*
- ◆ Provide assistance to homeowners who took too much risk and now are delinquent on their mortgage payments. On July 30, the “Housing and Economic Recovery Act of 2008” became law. This law was designed to provide up to \$300 billion for the

refinancing of about 400,000 mortgages whose default might lead to foreclosure. The program runs for three years starting October 1.

The plans were late in being implemented, but when they came, they came big. The Federal government is doing whatever it takes to restore confidence in the system. It will be messy. There will be complainers. Probably more government support will be needed. Tougher regulation will follow. We will likely go from under-regulation to over-regulation to better regulation over the course of the next couple of years.

INVESTMENT OUTLOOK

The government’s collective responses significantly lower the odds of a depression. Our valuation and sentiment indicators are sending a strong message that buying opportunities have been created by broad-based investor capitulation. Price-to-earnings multiples of stocks have been compressed. The difference in expected return between stocks and bonds (both government and corporate) is quite high relative to historical levels. The S&P 500 dividend yield has risen above risk-free Treasury bill rates, a condition that has traditionally lured sidelined cash back into the market. As we write, the amount of cash in money market accounts and savings deposits is equal to a whopping 70% of the total market value of the S&P 500. This percentage is consistent with the cyclical market bottom in 2003.

While the factors listed above are positive, the outcome of these policy actions cannot be known with any precision as they play out over the coming weeks and months. One thing is clear: over the next two years, the risk of slower economic growth and higher inflation has risen. Deleveraging the financial system coupled with the issuance of so much government debt to fund TARP and like programs contributes to this possibility. Yet, on the positive side, the recent dramatic drop in commodities prices offsets global inflationary pressures for the near-term especially in fast growing resource intensive economies such as China.

Finally, even assuming the government stimulus plans are effective in “unclogging the financial pipes,” it is almost a certainty that a global recession is already underway. At a minimum, the economy will take some time to improve.

CONCLUSIONS

With all of the recent legislation passed, the probability of a protracted severe recession is much lower. But we do have a global recession to contend with that is likely to last at least through the first half of 2009.



It appears that mutual funds and hedge funds are liquidating assets to the degree that they appear to be indiscriminately selling to meet redemption calls. According to one firm that tracks fund flows, nearly \$22 billion flowed out of global equity funds in September, the most ever recorded.

Assuming a depression will be avoided, stocks exposed to global growth have dropped so far in price that they are attractive on a valuation basis even if their earnings falter through this recessionary period. These companies are well positioned for continued infrastructure expenditure, which is utterly necessary on a global basis. Consumer non-durables, are also candidate for increasing exposure because of their potential for consistent dividend growth and less price volatility.

We cannot see good value in fixed income. Long bonds would be an attractive investment in a very deep, protracted recession, but otherwise, long bonds are unattractive because of their low yields.

With all of the above in mind, the actions we took earlier in the year remain in place and relevant going forward, which included:

- ◆ Placing all cash in the safest money market accounts available to us.
- ◆ Ensuring that the securities in accounts cannot be lent out (for the purpose of short selling by other entities) to other institutions for accounts that did not need margin capability.
- ◆ Continuing to have limited direct investment exposure to the residential real estate and related markets.
- ◆ Reducing our overall exposure to equities toward the end of June.

On the last point, we are maintaining our below average equity weighting, but that could change.

We are and continue to be concerned and most focused on the portfolio value. We will continue to be methodical in our process that spared us from a lot of the financial damage through August. However, the global liquidation of equities in September has taken its toll on prices and affected our client portfolios. In these volatile and emotional times, we are especially cognizant of remaining analytical in our approach. The market has a way of flushing participants out at the wrong time. Of paramount importance is having enough liquidity on hand in order to avoid being a distressed seller, which we are not.

CHATHAM CAPITAL GROUP

With all that has occurred in the financial services industry, we wanted to reiterate some fundamental factors undergirding our firm:

- ◆ Wealth management advice is the only service we provide. We offer no insurance products, no banking products or investment banking. As providers of unbiased advice, we serve your interests solely.
- ◆ The principals of Chatham collectively own the firm in its entirety. We answer to no one other than our clients and ourselves.
- ◆ Our company's financial structure is like that of a typical accounting or law firm in that we have no debt.
- ◆ We are organized so that your primary contact is with a principal of the firm. Since our inception, no principal has left the firm, and we have experienced very limited turnover among our valuable administrative staff.

We know that there is a lot of anxiety given the state of the economy and the capital markets. Our focus is on your long term financial well-being. We are doing all we can to ensure that it is sustained.

Chatham Capital Group, Inc. is a privately owned investment advisory firm. The firm provides comprehensive financial counseling and investment management services to individuals, trusts, endowments, and foundations. Chatham is registered with the Securities and Exchange Commission under the Investment Advisors Act of 1940. The operating principals own the firm and have over 150 years of combined investment experience. The investment management fee on the Chatham Trusts and Partnerships is 1% on all amounts.

PRINCIPALS

Bruce D. Fielitz, DBA, CFA® William J. Fielitz, CHFC, CFP® Frederick L. Muller, CFA® Frederick R. Muller, CFA® L. Guy Palmer, II (Consultant) Philip B. Palmer, CFA®

INVESTMENT SERVICES

- Separately Managed Accounts
- Pooled Trusts (for tax-exempt retirement funds and IRAs): Small Cap Trust, Balanced Trust, and Equity Opportunity Group Trust
- Pooled Partnerships (for taxable accounts): Small Cap Partnership, Balanced Partnership, and Equity Opportunity Partnership
- Asset Allocation Consulting for Retirement Plans

We invite you to visit our website for more information on Chatham Capital Group at www.chathamcapitalgroup.com and Chatham McKinley Partners, our family office, at www.chathamckinley.com.