

## **2008 IN REVIEW**

What began in the summer of 2007 with an increase in delinquencies and defaults on mortgages of U.S. residential real estate eventually spread across the global economy. This came to a head in the fourth quarter of 2008 with dramatic declines in virtually every form of economic activity and investment asset value.

The problems began as a fundamental issue—deteriorating loan quality—but evolved into a confidence issue questioning the viability of our entire economic system. Rapidly falling levels of business, consumer, and investor confidence to record or near-record lows has led to significantly less overall economic activity and lower asset prices. Those with capital have become more hesitant to part with it and continue to hoard cash, mostly in short maturity Treasury bills.

Almost two years ago, we anticipated problems in the residential real estate market and its potential spill-over effects on the financial services industry. Thus, our exposure to real estate and financial institutions was very limited going into 2008.

Our action to raise some cash this past June by selling consumer spending oriented stocks, which we believed would be the next shoe to drop, also proved to be a good one.

At the same time, we underestimated the severity of the bursting of the real estate bubble. We did not anticipate the ubiquitous domino effect that poor quality loans, structured in securitized form, would have around the globe.

Unlike past recessions and bear markets in investment assets, this time there has been virtually no part of the private economy or capital markets that has not been dramatically impacted. Simply avoiding those areas of the economy directly associated with the real estate bubble was not sufficient to avert investment losses.

## **INVESTMENT OUTLOOK**

By almost every measure, the economy is in ill health and the fundamental news will continue to worsen over the coming months.

We expect a hard recession is in front of us, but not a depression. Unemployment will undoubtedly rise further from the present rate of 6.7%. Corporate profits will decline further.

Housing prices have not yet stabilized. Global GDP is declining, and credit availability is limited, especially to individuals and small businesses.

Offsetting that bleak picture is the fact that around the world, and particularly in the U.S., government policy response—both fiscal and monetary—is in high gear and will ratchet up even more under the new Presidential Administration and Congress.

In time, we believe that collective government actions will begin to repair the lost confidence of businesses, consumers, and investors to invest and spend. This will ultimately have a positive effect on credit markets and growth in GDP.

It is important to point out some powerful fundamental strengths that positively affect the private sector at present. These are the healthy balance sheets of most major industrial companies, declining rates of inflation, and low interest rates.

The stock market generally anticipates what will occur several months into the future, as it did by going down 50% in anticipation of the serious recession now underway. Currently, stock values are cheap by most conventional measures with many leading companies offering dividend yields higher than short term money market funds. Before it is evident that profit growth is beginning to turn positive, equity prices should move higher from their present low levels.

The main risks to our outlook are that: (1) government policymakers respond to populist calls for protectionism that would reduce global trade; (2) they impose punitive taxes on entrepreneurial capital—the seed corn of innovation, growth, and job creation; and (3) they begin to overregulate. The new Presidential Administration, however, appears to be fully aware of these risks. The question is whether they will have the political will to resist the enormous pressures from certain constituencies that would hobble long term productivity growth in the private sector. We believe the new Presidential Administration will prevail with wise, informed policies, at least until the economy recovers over the next year or so.

## **CONCLUSIONS**

The spending and stabilization policies initiated by the U.S. and foreign governments are likely to begin the arduous process of restoring confidence. But it will be some time before the effects are noticeably visible within the real economy—probably months.

Assuming government actions do work, most investment assets, especially stocks, are cheap when compared to holding cash that currently earns almost nothing.

Based on the investment merits alone, increasing exposure to “risky” assets (stocks, real estate, etc.) makes sense, but we are not doing so at present because:

- a) Individuals have a finite amount of investment assets to sustain them, and increasing risk exposure at a time when portfolio values are already so far down is unsettling.
- b) Some of the cash raised last June has already been reinvested.
- c) We want to protect the capital that will be needed for all foreseeable withdrawals.

Therefore, our investment strategy is to:

- ◆ Maintain sufficient short term reserves to facilitate planned client withdrawals over the next few years.
- ◆ Stay the course with the present equity commitment—we note that as of December 31, the S&P 500 Index is up 20% from its low point on November 20.
- ◆ Continue seeking out better investment opportunities to swap for present holdings.

### 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 our clients’ 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 our clients’ 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 long term financial well-being. We are doing all we can to ensure that it is sustained for our clients.

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#### INVESTMENT SERVICES

- Separately Managed Accounts
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