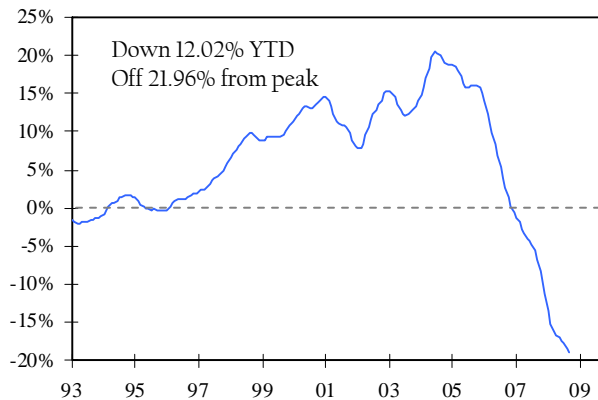


December 31, 2008

Financial destruction might be the best way to summarize the events of the fourth quarter and the year just ended. At the heart of the problem was the continued decline in home prices, which are down over 20% on average from their peak as the chart below clearly demonstrates.

S&P/Case Shiller Index, 12 Mo ROC



Source: Stephens Capital Management

The only asset class that was left unscathed was Treasuries as investors sought the safety and security that only U.S. government bonds can provide. As a result, the ten-year Treasury started the year at 4.02% and ended the year at 2.21%. With the bankruptcy of Lehman Brothers and the subsequent government take over of AIG, spreads between Treasuries and corporate bonds widened sharply to levels not seen since the 1930's. Agency spreads also widened out despite the government putting Fannie Mae and Freddie Mac under its conservatorship. Typical was the spread of the 5-year Fannie Mae over Treasuries which began the year at 51 basis points and reached 160 basis points before closing the year at 77 basis points.

The other big story of the year was inflation. As we had predicted, inflation rose sharply in the first half of the year as a result of the surge in the price for oil. However, as oil descended from its all-time high of over \$147 in July to close the year at \$45, the inflation picture has rapidly changed. As a result of the decline in oil and, more importantly, from prior action taken by the Federal Reserve with regard to monetary policy, the second half of the year saw inflation turn into the initial onset of deflation. It is our belief that this bout of deflation will persist through the course of 2009, the first full year of negative CPI since 1955.

The federal government's response to the credit crisis is being waged on two fronts - fiscal and monetary. The federal deficit is expected to exceed \$1.2 trillion in its fiscal year 2009. Net U.S. Treasury issuance may rise from just over \$400 billion in Fiscal 2008 to perhaps three times that amount in Fiscal 2009. In the final six months of 2008, the Fed has increased the monetary base from \$860 billion to \$1.7 trillion. From the commitments that have been made, it is apparent that the government is determined to avoid the mistakes of the early 1930's when government action proved inadequate for the challenges of that era. In 2004, then Fed Governor Ben Bernanke co-authored a paper entitled "Monetary Policy Alternatives At The Zero Bound: An Empirical Assessment" outlining his prescriptions for combating deflation.

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His “play book” could be summed up as follows:

Bernanke's Prescribed "Playbook" to Counter Deflation

- Step 1: Lower Fed Funds to zero
- Step 2: Expand the range of collateral accepted for loans
- Step 3: "Quantitative Easing" - Massive expansion of Fed balance sheet
- Step 4: Targeting of interest rates for a longer dated Treasury and non-Treasury debt

As a result of the dramatic action taken by the Federal Reserve, we expect the bout of deflation to be short lived. As we have often mentioned to you in previous commentaries, the growth rate of the monetary base by the Fed is the primary determinant of inflation in the long-term but it takes roughly 18 months for its impact to be felt in the economy. With growth rate of the monetary base approaching 100%, inflation should begin to reappear as 2009 ends and 2010 begins. Doubtless the Fed intends to remove the excess monetary base before it can cause an undesirable amount of inflation. However, in order to do that, they will need an economic recovery to have taken hold so that they will be free to raise interest rates. If the economy does not cooperate in 2009, as we fear it won't, the Fed will be faced with some very difficult choices. They will have to decide if they want to slow the economy in order to prevent accelerating inflation or sacrifice its fight against inflation for the sake of the economy. Our current thought is that the risk is greater and that they will err on the side of stimulating the economy which could allow inflation to reignite to uncomfortable levels. Barring new developments, we intend to gradually begin the process of preparing our portfolios for rising inflation by taking positions in certain Treasury Inflation Protected Securities (TIPS) and shortening our durations. Even so, we will continue to be diligent and mindful as we navigate these tumultuous markets on your behalf.



The views expressed in this commentary were those of the portfolio manager as of the publication date and are subject to change without notice. The performance data quoted does not reflect the deduction of advisory fees and other account expenses. Our advisory fees are available in Part II of our ADV or the appropriate brochure. Performance results represent past performance and do not guarantee future results. Market volatility can significantly impact short-term performance. Actual results of an investment made may differ from the composite results, depending on the size of your account, the duration of the account, the investment objectives and/or restrictions, the time at which your investments are made, and other factors.

William Tedford has developed and uses a proprietary model designed to forecast inflation. The model reflects past and historical relationships of inflation to monetary base and oil prices. The future behavior of inflation is influenced by many factors (many of which are themselves unpredictable) and will not necessarily continue to follow historical patterns. The model, by itself, cannot guide an investor as to what securities should be bought or sold nor as to when to buy or sell.