

This letter is dated July 2008

The best time to buy stocks is at the point of maximum pessimism.

Sir John Templeton

Sir John Templeton, one of the world's most successful investors, recently passed away at age 95. At a time when the credit crisis, housing market decline, the collapse of Bear Stearns and a record oil prices dominate the news, I believe the above quote to be most apropos. Why do I believe this? Because much like John Templeton, we have a fundamental core belief that stock prices correlate to companies' underlying fundamentals over the long-term. In the short-term, however, a multitude of extraneous factors can diverge the two, even sending them in opposite directions. This divergence, in our opinion, disputes the Efficient Market Theory and provides opportunity for those with strong stomachs and a long-term perspective. Many cases currently exist today, in our opinion, where the actual underlying fundamentals are stronger the prevailing stock price indicates.

The past decade stocks, as measured by the S&P 500, have provided a minuscule annualized rate of return of +1.2%¹, despite profits of the underlying companies having increase by average annual rate of +8.5%² during that same time period. This gap, in our opinion, is primarily due to two factors: The overly optimistic prices assigned to stocks 10 years ago and the overly pessimistic prices assigned to stocks today.

This letter highlights some historical economic and market performance data as well as particular aspects of our approach to investing that you may find comforting in these times of turmoil and economic distress.

Wisdom of Cash Reserves

The one portfolio management question I've been asked more than any other over the past five years is "Why do we have so much cash in my portfolio?" Our general approach toward cash positions is summarized below, in order of priority:

- 1) Sufficient cash must be maintained in a checking account for on-going daily cash needs, with an identified income source for replenishing.
- 2) In addition to the expected daily cash needs, life is full of surprises. These surprises often come with a price tag. A cash reserve account at Smith Barney or at your local bank may serve this purpose; being available in the case of an emergency or other unexpected cash need.
- 3) Above and beyond the cash designated for expected daily needs and the cash reserve account for the *unexpected*, we typically maintain a third significant pool of cash in our long-term investment portfolios. This cash is designated for possible future investment. In the event an investment opportunity arises, we may purchase the investment with this cash, avoiding the need to sell an existing holding to do so. In the event of a significant decline in the broad market, this third cash pool is earmarked as a potential source of funds to invest, in hopes of buying an attractive long-term investment at a prevailing bargain price.

Peace of mind is a possible, yet an immeasurable, benefit to our cash approach delineated above. Declines in the equity markets, like we have experienced recently, are not enjoyable by any stretch of the imagination. However, having ample cash reserve and income sources to cover daily cash needs plus a back-up cash reserve for emergencies can make the drops in the Dow a bit easier to stomach. You've likely heard me say on more than one occasion: "A sharp decline in the stock market is only tragic if the investor has to sell to meet his or her cash needs". The first two cash pools referenced above are for the purpose of avoiding the 'tragic scenario'. These reserves we recommend, which at times might seem like idle funds actually play a vital role in allowing investors to ride out the inevitable and unpredictable ups and downs of the stock market. The third pool of cash referenced can possibly take the benefits a step further by exploiting the

market turbulence, offering the wherewithal to add potential bargains at or near market troughs.

Food For Thought

"When asked about the country's economy, schools, health care or community spirit, Americans tell pollsters the situation is dreadful. But when asked about their own jobs, schools, doctors and communities, people tell pollsters the situation is good. Our impressions of ourselves and our neighbors come from personal experience. Our impressions of the nation as a whole come from the media and from political blather, which both exaggerate the negative. The latter has never been thicker." --- Gregg Easterbrook "Life Is Good, So Why Do We Feel So Bad?" The Wall Street Journal, June 13, 2008

S&P 500³ Performance during the four most recent past recessions¹

+12.7% January 1980 – July 1980 (Oil Shock, Rising Unemployment)

+5.6% July 1981 – November 1982 (Significant Budget Deficit, Tightened Money Supply, Higher Interest Rates in an effort to tame inflation)

+4.8% July 1990 – March 1991 (Savings & Loan Crisis, Desert Storm)

-8.1% March 2001 – November 2001 (Dot.com bubble collapse, 9/11 attacks, corporate accounting scandals)

S&P 500³ Post Election Market Performance⁴

Below is the average annualized rate of return for the S&P 500 for the 10-year period following each Presidential election since 1936.⁵

1936 +8.3% Franklin D. Roosevelt vs. Alf Landon, U.S. Economic Depression, Nazi rise in Europe

1940 + 9.1% Franklin D. Roosevelt vs. Wendell Willkie, Germany menaces Europe; France falls

- 1944 +14.3% Franklin D. Roosevelt vs. Thomas Dewey, Wars continue, FDR's health in question
- 1948 +16.4% Harry Truman vs. Thomas Dewey, Berlin blockade accelerates Cold War, Civil Rights tensions boil over at convention, "Dewey defeats Truman" election uncertainty
- 1952 +16.4% Dwight Eisenhower vs. Adlai Stevenson, attempts at Korean War truce fail, McCarthyism sharpens partisanship, U.S. detonates first hydrogen bomb
- 1956 +11.1% Dwight Eisenhower vs. Adlai Stevenson, Montgomery Bus Boycott, Soviet invades Hungary, Egypt seizes Suez Canal
- 1960 +7.8% John F. Kennedy vs. Richard Nixon, Cuba Nationalizes U.S. assets, American U-2 spy plane shot down in Soviet airspace
- 1964 +6.0% Lyndon Johnson vs. Barry Goldwater, Gulf of Tonkin signals Vietnam involvement
- 1968 +3.6% Richard Nixon vs. Hubert Humphrey, RFK & MLK assassinated, Vietnam protests, civil rights issues roil conventions
- 1972 +6.5% Richard Nixon vs. George McGovern, Watergate scandal, Vietnam War drags on
- 1976 +14.3% Jimmy Carter vs. Gerald Ford, New York City near bankruptcy, economic recession
- 1980 +17.5% Ronald Reagan vs. Jimmy Carter, U.S. economy remains in a slump, Iran hostage crisis, Olympic boycott underscores Cold war divide
- 1984 +14.9% Ronald Reagan vs. Walter Mondale, budget deficit rising rapidly, stock market slides over 30% in < 4 months, Mideast discord, Marines withdraw from Lebanon
- 1988 +18.0% George H.W. Bush vs. Michael Dukakis, Savings & Loan crisis reach apex

1992 +12.9% Bill Clinton vs. George H.W. Bush, Los Angeles riots,
Pending NAFTA ratification

1996 +9.0% Bill Clinton vs. Bob Dole, UN arms inspectors repeatedly
thwarted in Iraq, Saudi Arabia bombing kills 19 American servicemen

2000 N/A⁶ George W. Bush vs. Al Gore, Supreme Court decides
controversial election, Tech bubble burst, stock markets plummet,
USS Cole attacked

2004 N/A⁶ George Bush vs. John Kerry, Oil prices soar, On-going war in
Iraq, Abu Ghraib photos appear, campaigns trade accusations on
military records

2008 N/A⁶ Barack Obama vs. John McCain, economy slumping,
unemployment rising, sky high oil prices, housing market collapse,
credit crisis, on-going war in Iraq

Summary

The U.S. stock market has declined over 20% from its peak in October of 2008, and we believe the currently depressed stock prices provide an opportunity for long-term investors to buy stocks at a possible discount to their intrinsic value. This is a recipe for better days ahead, in our opinion.

As always, please don't hesitate to call if you have any questions or concerns. We appreciate your trust and confidence.

Paul D. McCauley
July 2008

¹On July 31, 1998, the S&P 500 closed at 1,120.67. On June 30, 2008, the S&P 500 closed at 1,267.38 for a +13.1% cumulative return (+1.2% annualized). Source: Reuters

²Based on a 2008 earnings estimate of \$86.00 for the S&P 500 compared to earnings of \$38.23 (Source: Reuters) for the S&P 500 in 1998. Cumulative increase of +124% (+8.5% annualized). Source: Reuters

³A bear market is considered to be a decline in stock market value of 20% or greater. The S&P 500 Index declined 24% from its peak in October 2007 of 1,576.09 to a low in July 2008 of 1,200.44. Source: Reuters

⁴Information obtained from Turner Investment Partners piece titled "Understanding Recessions". Past performance does not guarantee future results.

⁵Per the American Funds, Capital Research

⁶N/A = not available as the 10 year time period has not yet elapsed S&P 500 Index is an unmanaged, market value-weighted index of 500 stocks generally representative of the broad stock market. An investment cannot be made directly in a market index.

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Indices are unmanaged. An investor cannot invest directly in an index.

For index, indicator and survey definitions referenced in this report please visit the following: <https://www.morganstanley.com/wealth-investmentsolutions/wmir-definitions>

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CRC 4770801 08/2025