February & March 2009

Monthly Investment Commentary

Commonwealth Bank & Trust Company

4350 Brownsboro Rd.
Suite 210
Louisville, KY 40207

p (502) 259-2500
f (502) 259-1501
www.cbandt.com

After a dismal 2008, investors continued to get slammed through the first two months of 2009. After falling another 10.7% in February, the S&P 500 (based on Vanguard Index 500) is down 18.2% at the end of February. Growth has continued to sharply outperform value by losing less, with the iShares Russell 1000 Growth dropping 7.5% in February and 12% in 2009, while its value counterpart lost 13.3% in February and is off 23.3% this year. Developed market international stocks were down by similar amounts to broad-based U.S. indexes, but emerging market equities have held up better, losing 6.1% in February and 13.8% year to date. High-yield bonds, which we have considered a substitute for equities, have performed well, up 1.8%, while investment-grade bonds were down 0.4% in February and 1.1% on the year. Below is a summary of how we are responding to the challenging market environment.

What can Investors Do

With markets dropping below the lows of last November, things are feeling as bad to investors as they've ever felt. Leaving the question, what should an investor be doing?

Amidst a painful experience, the desire to "do something about it" can be overwhelming. Being powerless, and subject to forces totally beyond your control, can be frustrating and scary. The fact that our financial well-being is at stake adds to these powerful emotions. Taking charge by selling out of equities in favor of cash may be the only control an investor can exert over this otherwise terrifying environment. For them, it creates a little bit of certainty amidst this otherwise scary place we're in. So what's wrong with that—why don't we just sit it out and wait for better times?

We have written repeatedly since early fall 2008 that we are in a changed world. Many of the lessons learned and reinforced over decades of investing have not applied in this market. But, one thing that will remain true, regardless of the economic environment, is that making good investment decisions requires a rational approach in which careful analysis and thorough research, and not "emotion", underlie decisions.

What We Are Doing

In this challenging environment, we are maintaining a balanced approach to investments, and trying to ensure that portfolios are consistent with the long-term goals and objectives

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of our clients. It is easy to question why we would suggest having "any" exposure to equities in this type of market so we thought it would be beneficial to share what we are and are not doing in this environment, and why.

Thinking flexibly and considering scenarios more negative than some believe possible. We recognized late last year that this was not just another market decline when credit markets seized up, and adjusted our thinking to consider the potential negative outcomes. In many cases, this led us to become more defensive in our portfolio holdings and to introduce some alternative positions to attempt to hedge the risks. In hindsight (as is always the case), we wish we had moved more dramatically into defensive positions. However, we believe the moves we did make added significant value to portfolios relative to their benchmarks.

We are gathering as much data and information as possible to gain perspective and make reasoned decisions in the midst of a rapidly changing and uncertain environment. Our ongoing research is based on a wide variety of sources, including analyzing in-house and third-party data, and reading a wide variety of opinions and analysis from independent experts. We also have an extensive network of investment contacts built over the years that is a valuable resource for us. During the immediate crisis last fall, we drew on this network to get a view from investors with boots on the ground about what was happening in the financial markets. This helped us understand early on the impact of the credit freeze, the impact of forced selling by hedge funds, and where longer-term opportunities were being created. We continue to get insights from outside experts to help us gain perspective and make sound decisions. Obtaining this information and augmenting our own work helps us stay grounded and make decisions with confidence amidst this highly challenging and uncertain environment.

We have increased our asset class research analysis. Over the past few years we have greatly increased our asset class research and now regularly follow over 13 asset classes and investment styles. Given the potential impact of the macro environment on asset classes, we believe this research is now more important than ever. The huge level of market volatility has also required us to be able to make decisions more quickly in order to act on compelling opportunities as they are presented to us. As a result, we are digging deeper in our asset class work to make portfolio allocation decisions as opportunities arise. Our asset class work will continue to evolve as we get our hands on new data, retest assumptions, cross-check our work with other investors and experts and as overall conditions change. But, we are con-

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fident that our process is sound and will allow us to make longer-term allocations decisions with higher confidence.

Our stock selection philosophy and process is well suited for this environment. Our stock selection process is focused on buying world-class companies at the right price; an approach we believe is ideally suited to be successful in this market. As always, we focus on three things when considering a company for investment: first and foremost, we require that it be a solid company with strong competitive advantages; secondly, we want to invest in companies that have talented and shareholder-friendly management teams; lastly, we only invest in companies that are reasonably valued to provide solid long-term returns. By being disciplined in these three areas, we are able to find companies that will survive these difficult times as weaker competitors go out of business and who are likely to emerge from this crisis stronger than ever relative to their competitors. We are very confident that our security selections are trading at valuation levels that will handsomely reward patient long-term investors.

We are continuing to make decisions based on assessing risk and reward over our longer-term investment horizon. It is never easy to make decisions when uncertainty is high. But the uncertainty mainly revolves around what markets might do in the shorter term, and that is something we know we can't predict accurately. There is longer-term economic uncertainty, but we can still assess potential returns after taking into account a very poor scenario that encompasses even the most negative end of that "cone of uncertainty." By doing this, we can make decisions with confidence if we believe we'll earn reasonable longer-term returns under even pessimistic scenarios.

What We Are Not Doing

The environment we entered last fall is one in which we believe the global economy will be forced to reset to a lower level over at least several years as debt and spending are sharply reduced. One might believe that having confidence in this assessment would be enough to ensure good investment decisions. But while the macro environment may be new, what remains the same is that what matters from any point forward is what is being discounted in asset prices.

We are not going to completely eliminate exposure to stocks and wait on the sidelines until things improve. Our investment approach is based on long-term return expectations. This is a bit of an oversimplification, but the core analysis behind our return expectations is based on what we think corporate earnings could be in the years ahead, and the price (P/E) at which stocks might sell at the end of our forecast period. We look at a range of broader economic scenarios, and even in the negative scenarios stocks are priced

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to deliver decent returns, with the potential to surprise to the upside.

So, while we are confident that from current levels stocks offer good longer-term return potential, we don't know what might happen in the shorter term. Stocks could drop further, or they could rebound sharply. If we try to predict this and invest accordingly, we have to consider the consequences of being wrong. If we go to cash, the market could rebound sharply before we can get back in. It is possible we could see a rally of 20% to 30% before concrete signs of sustained economic improvement appear. This is because the market is forward looking and nearly always reaches a bottom well before the economy reaches a bottom. If that happens, we could see a material portion of the good multi-year return potential that we believe exists realized in a short time. At that point, we'd need to decide whether the market's turn was going to be sustained, and get back in, or continue to wait and risk losing further upside. If we did get back in, we could be whipsawed if the upswing proved to be temporary, as commonly happens during severe bear markets.

On the other hand, if we remain invested, our analysis gives us confidence we will earn a good return over a several year time horizon, independent of what the short term brings. We also know that we will continue to see tactical opportunities amidst the near-term weakness, and that will provide us the opportunities to pick up great securities at attractive prices that have been sold based on fear, not fundamentals.

We are not going to try to time the bottom of the market and add equities at their cheapest point. Successful investors find the best opportunities during the deepest pain of a bear market. This is difficult because the fear that made an investment cheap relative to its longer-term potential will almost always make it even cheaper in the near term. Because no one knows where the bottom is, and because a rebound can be sharp, taking advantage of a deeply undervalued investment requires the willingness to accept more downside in the near term. In our case, if declines continue, we will reach a point where we view stocks as enormously cheap, leading us to add to equities, and at that point the risk will feel very high. We will in all likelihood also see further near-term losses, which will make it even tougher. But, we also know that we won't have the opportunity to make our purchase at the bottom and that if we try we are more likely to miss the opportunity.

We appreciate your confidence in us and are thankful to continue serving you and helping you to achieve your financial goals.

- CB&T Investment Team 3/2009