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Monthly Investment Commentary

Commonwealth Bank & Trust Company

October was a gut-wrenching month. As September came to a close, ending a dismal quarter for financial markets, October began with a slide in stock prices that quickly accelerated into a near freefall spanning the first eight trading days of the month. As the credit crisis went global, and markets began to recognize the extent of the economic damage wrought by frozen credit markets, investors shunned risk of any kind and virtually all but riskless assets were hammered. A brief recovery was followed with a further selloff, and by late October the declines were extraordinary. At one point, REITs—which were among the only asset classes to hold up in the third quarter—were down over 40% in October alone. Emerging market equities were off by more than 60% from their highs earlier this year. High-yield bonds fell to levels that sent their yields above 18%. In the final days of the month, markets lurched sharply higher, but the damage was still excessive. Large-cap U.S. stocks (as measured by the Vanguard 500 Index Fund) were down 16.8% in October, and almost 33% this year. The smaller-cap iShares Russell 2000, after beating large-caps soundly in the third quarter, underperformed in October with a loss of almost 21%, with little solace in their 29% year-to-date loss putting them down a little less than large-caps. Foreign stocks finished with a 22.1% loss, with part of the loss caused by the dollar rallying sharply in October. Other sectors were hammered as well in October. Of those mentioned previously, REITs dropped by 31.2%, emerging markets equities were down 27.7%, and high-yield bonds fell 16.3%. Vanguard Total Bond Market Index Fund, which includes Treasuries, lost 2.5%, while intermediate-term, investment-grade corporate bonds were down by almost 6%.

What Are the Markets Pricing In?

As we write this, credit markets remain dysfunctional (though money markets are finally improving), financial markets have been amazingly volatile, and the economy is rapidly deteriorating. Stocks remain volatile and we continue to be concerned that the extreme deleveraging of the financial and household sectors will result in a deep recession and later, a subpar recovery.

Outside of U.S. Treasury securities, there has literally been no place to hide in this downturn. Due to the wide-spread sell-off in financial assets, even well diversified portfolios suffered large losses over the past three months. However, with prices in almost every asset class having taken a massive hit, we know that going forward, return potential is far better than it was a few months ago. Consider the trailing three-month returns as of 10/31/08 (see right).

Trailing 3-Month Return as of 10/31/08	
S&P 500	-23.11%
Small-Cap Stocks	-26.72%
International Stocks	-35.74%
Emerging Markets Stocks	-44.15%
REITs	-29.76%
Commodities (Credit Suisse)	-35.47%
Gold Bullion (SPDR Gold)	-21.57%
High Yield Bonds (iShares)	-23.47%
Emerging Markets Currency ST Bonds (PIMCO)	-20.33%
Emerging Markets Dollar-Based Bonds Emerging Mkts (iShares)	-20.92%
Foreign Developed Markets Bonds (PIMCO)	-15.06%
Corporate Bonds (iShares)	-13.08%
TIPS (iShares)	-11.53%
Tax-Exempt Bonds (iShares)	-4.29%

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We also strongly believe that the fundamental economic and earnings outlook has been so significantly damaged that some of the declines we've experienced have been justified. But in some areas they have gone too far. Here's a quick summary of our current thinking on asset classes that are most interesting now:

U.S. Equities

Based on our market view, the most likely five-year return for stocks is now in a range of 8-12% (this is with the S&P at 950). However, we are concerned that with more saving and less borrowing, after a significant retrenchment the consumer won't come back strong for several years, making for a challenging earnings environment. Moreover, in coming years we are likely to have a more heavily regulated business environment and probably will need to have higher taxes to fund the coming surge in the deficit. So the probabilities could be skewed toward the lower half of our five-year potential return range. Moreover, if the bear market ends with stocks overshooting to deeply undervalued levels, stocks could still decline significantly from current levels. It is also very possible that stocks have bottomed. But regardless of what happens in the near term, stocks are priced to deliver at least mid- to high-single-digit returns over five years. However, and this is a big however, we believe the market dysfunction has created much better opportunities at a stock-picking level compared to the overall market's return potential, which is what our five-year return analysis is based on. The combination of fear and forced selling by hedge funds and others has resulted in opportunities to benefit from mispriced stocks. We believe strongly that our Core Equity approach to picking high quality stocks at good valuations can add substantial value in this environment once things begin to normalize.

High-Yield Bonds

Like many asset classes, high-yield bonds have sold off sharply. The Merrill Lynch High Yield Master Index now yields about 19%. It is certainly possible that bond prices could go lower, though the high interest yield would provide some offset to that risk. But like any investment, we consider a multi-year horizon and ask ourselves what outlook is in the price of the asset. We have evaluated the high-yield bond asset class assuming depression-level default rates and low recovery rates, and five-year potential returns are still double-digit, with returns in the teens likely. With interest income well into the teens, a lot of default losses can be offset. The return dynamics are also aided by the fact that high-yield bonds pay high interest because they have already been marked down in price. So the average bond in the high-yield universe is priced at just over 60% of par (par is the value paid at maturity). Since even defaulted bonds almost always return some capital, the potential loss from default is not as great as one might think. And for all the bonds that don't default, investors capture a

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very high yield. Looking out five years when the economy is better, the bonds that are still around are likely to be selling at lower yields, so bond prices should be higher. The biggest negative is that most of the return is taxable as ordinary income, so the economics are much better for tax-exempt investors.

REITs

REITs were pummeled in October and have lost about 40% of their value since May, though they have had a powerful rebound the last week of October. Before their four-day 26% rally at the end of the October, REITs were briefly in fat-pitch territory but the rally closed the window for now. So much for low beta and low correlation. Investors are anticipating a hard landing for commercial properties and are particularly worried about the retail, hotels, and office sectors. Their concerns are well founded but by our calculation REITs are already pricing in a 30% decline in property values. When we evaluate our outlook for negative dividend growth over five years we come up with a mid-single-digit return. With a less pessimistic but still conservative outlook, it is very possible that returns could be over 10% over that time period. If REITs underperform domestic equities again, and stay depressed (relative to equities) for more than a few days we may consider adding some REIT exposure to portfolios. In the meantime, we will continue to patiently watch the asset class.

Emerging Markets Equities

Even after their huge move up in the last few days of October (about 28%), emerging markets equities are down about 55% from their peak of about a year ago. The “decoupling” thesis has been at least partially discredited as it has become clear that the developing world will not be immune to the downturn in the U.S. and Europe. Like our other asset classes, we evaluate emerging markets for negative outcomes, in this case factoring in a 50% decline from peak earnings and only moderate growth after that. Even in that scenario, the asset class could deliver a five-year annualized return in a high single-digit to low double-digit range. Of course over the near term, emerging markets are potentially one of the most volatile of the asset classes we monitor. Like REITs, we are content to sit on the sidelines for now, but are watching the asset class closely for a potential buying opportunity.

Bonds

TIPS, corporate bonds, and tax-exempt bonds have all sold off sharply. Only tax-exempts have started to recover. Corporate bonds in particular look to be extremely oversold though it is hard to know when they will rebound. BAA bonds (still investment grade) now yield close to 10%, while high-yield bonds are yielding near 19%. Overall, we see little long-term value in

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Treasury bonds, however they are likely to be a safe-haven as the economy weakens and the financial turmoil continues. Other parts of the bond market like TIPS, investment grade and high-yield corporate bonds offer good long-term value, but face near-term uncertainty in this environment. We are also seeing good buying opportunities in municipal bonds and believe on a tax-adjusted basis municipals are a very attractive fixed income option.

Strategy

Near term the market seems to be in a trading range around the lows of October, at this time we do not know if we are seeing a move off of the bottom. It could be, but given the severity of economic problems, we suspect it is not. Severe bear markets typically have strong rallies followed by a re-test or breakthrough of previous lows. In both 1973-1974 and 2000-2002 there were 20% rallies within those bear markets. One of many challenges we've faced has been dealing with the incredible market volatility, where huge moves from day to day and even within a day can quickly present opportunities, then take them away. The flip-side of all of this volatility is that it creates some excellent buying opportunities in great investments. We plan to stay with our disciplined investment approach and look for opportunities to buy great investments that have the potential to outperform their benchmarks. We greatly appreciate your trust in us and we will do our very best to guide you through these challenging times.

- CB&T Investment Team 11/2008