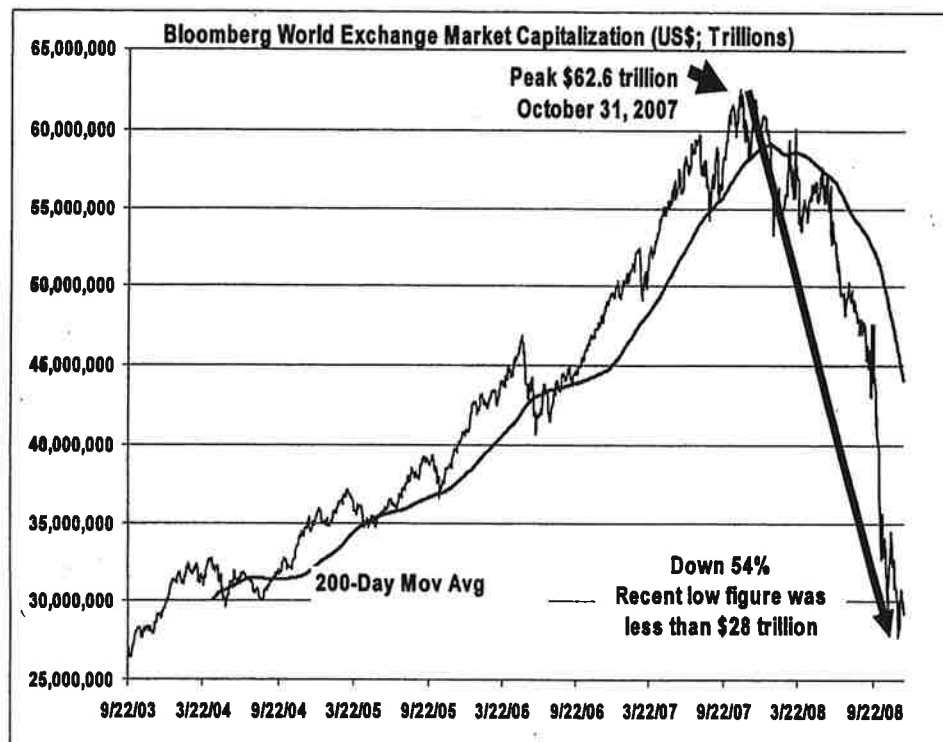


## INVESTMENT REVIEW AND OUTLOOK

What is left to say about the financial events of 2008? It was, quite simply, the worst year that almost any living investor has experienced. The breadth and depth of wealth destruction, encompassing nearly all asset classes and geographies, was shocking. After peaking in October of 2007 at \$62.6 trillion, total worldwide market capitalization fell to approximately \$28 trillion in less than twelve months. (See chart) With the exception of cash, government securities and gold, there were no safe havens. The list of alternative investment strategies that were thoroughly discredited is long and even the tried and true concept of diversification proved to be of marginal utility. Correlations converge in a financial crisis, particularly one that qualifies as a “black swan” event. Even the so-called “Yale model” – hugely successful over the years – turned out to be a crowded, illiquid trade at the top of the market. *To preserve capital in this once in a lifetime bear market, one needed to make the first order decision to recognize it as such.* From there, the course of action was simple if somewhat uncomfortable: raise lots of cash. Our flexible investment process enabled us to do that, although significant losses were still unavoidable.



Source: Bloomberg and BCA Research

While the business press was busy chattering about various “bubbles” – from internet stocks to residential real estate to commodities – the mother of all bubbles, the credit bubble, was steadily and ominously inflating. It was the elephant in the room. This bubble to end all bubbles, spawned initially by abnormally low interest rates following the dotcom debacle of the late 90s, was global in scope and, in hindsight, at least a decade in the making. The Greenspan Fed kept rates too low for too long. This led first to irresponsible lending and borrowing in the housing sector and, ultimately, to irresponsible risk taking on a much broader scale. Credit or “leverage” was the special sauce for much of this risk taking. Of course, all of this occurred within the context of lax regulatory oversight, which only made matters worse.

***The problem with a credit bubble is that it infects everything, inflating returns and values across a wide range of asset classes and regions.*** The bursting of this credit bubble had the effect of a huge global margin call, setting in motion a history making deflationary spiral of institutional failures, asset devaluations and, more recently, governmental bailouts.

At this point it is widely acknowledged that we are in a serious global recession. The economic news is appalling and the list of concerns too numerous to mention in any detail here. They range from the credit crisis to rising unemployment to ballooning deficits to the imponderable question of whether deflation or inflation represents the greater peril going forward. Fortunately, the stimulative monetary and fiscal policy responses around the world have been as extraordinary as the problems they are meant to address. With respect to the current recession, the question now is: How deep and how long? A related, and perhaps more approachable question is: What economic outcome has already been discounted by the market decline to date and how soon might asset values begin to recover? Economic forecasting is an inherently futile exercise. Predicting the glide path of the current downturn is even more difficult because of the unprecedented nature of the situation we find ourselves in. ***The severe drop in household wealth and resulting balance sheet repair/asset sale dynamic creates a deflationary backdrop that is beyond the frame of reference of most people today.*** We think investors continue to underestimate the power and duration of the current deleveraging cycle.

If the economic forecast is too difficult to make at this juncture, what about the question of valuations and whether they are low enough to compensate for the vexing set of problems we face? Here the news is a bit more encouraging. ***Remember, at the end of the day, it is not so much about getting the forecast right as it is about paying the right price for the asset in question.*** Global equities, particularly large cap equities, appear undervalued for the first time in many years. Most of the developed world has already experienced a 40-50 % drop in stock prices and the recession in the U.S. is 13 months old, long by historical measures. In the U.S., the dividend yield on the S&P 500 is higher than the yield on the ten year U.S. Treasury for the first time since the 1950s, creating an incentive for investors to begin to take on a little more risk. Certainly, the monetary authorities are doing all they can to coax investors back into risk assets by lowering risk free rates to historically low levels. Meanwhile, there is a massive amount of cash on the sidelines as investor sentiment remains extremely negative. There is the potential for an explosive upside move at the slightest hint of stabilization in the economic fundamentals and investor confidence.

At this point in our commentary we would normally opine at some length on the market outlook and highlight specific sectors and securities that we favor. However, the current situation is inherently unpredictable given the fluid nature of the financial crisis and the fact that global policy makers are taking unprecedented actions more or less on the fly. ***These historic policy moves will surely have equally historic economic consequences, some of them intended, many of them unintended. The regulatory and economic footprint of the government is going to be much bigger in the future, and this alone is a game changer.*** With these uncertain times, as well as the disturbing Madoff scandal in mind, we thought we would take this opportunity to reiterate Moody, Lynn & Co.'s core philosophical and investment principles and to outline in a more general way the actions we are taking to preserve and grow capital in these challenging times.

### ***First Principles***

- Client First:*** This one speaks for itself. Not only is it ingrained in the Moody, Lynn & Co. culture, but our independent structure and investment, rather than asset-gathering mind set, helps us to maintain it.
- Be Flexible:*** As we mentioned, the economic fundamentals today are beyond the experience of nearly everyone. Methodologies that were effective and interrelationships that held in the 80s and 90s may not be relevant to the current period. In an investment counseling context, being flexible might mean the willingness to raise cash to preserve capital, to hold gold as a currency hedge or to consider inverse ETFs. Given a compelling risk/return profile, flexibility might also involve a willingness to consider buying bonds in an “equity” account. ***The point is that it will be more important than ever to think opportunistically and to move away from fixed policy guidelines, traditional benchmarks and rigid dogmas.***
- Keep it Simple:*** By simple, we don't mean unimaginative (see above). We mean understandable, transparent and liquid. At the height of the bubble, hedge funds and all manner of alternative investment vehicles were highly sought after. The number of hedge funds, funds of funds, and worse, “feeder funds” grew exponentially. In the case of the middlemen, they were selling two primary things: due diligence and access. ***With the Madoff scandal, the due diligence process, at least as practiced by many, was laid bare.*** The access was, by implication, access to extraordinary returns. Yet, extraordinary returns are, by definition, rare. In an environment where credit is neither cheap nor abundant, these returns will become rarer still, particularly net of the extraordinary fees charged. At Moody, Lynn & Co., the focus has always been on designing portfolios that are creative and diversified, but also *transparent, liquid and secure.*

### ***Current Portfolio Strategy***

***Stay Defensive:***

Maintain above policy cash reserve levels.

On the equity side, emphasize large cap, globally geared companies with low debt levels, strong cash flows and sustainable dividends. ***We see real opportunities today in the areas of infrastructure, healthcare, consumer staples and utilities. Select energy names look attractive as well.***

Where appropriate, increase exposure to high grade bonds, which offer a better value proposition than many stocks at this juncture

***Maintain Gold Hedge:***

Gold offers the potential for long run protection against inflation and continued currency devaluations. It has dramatically outperformed the S&P 500 over trailing one and five year periods.

***Utilize Inflation Protected Securities:***

TIPS offer the highest safety and, at current prices, inexpensive inflation insurance.

***Be Ready To Incrementally Increase Risk:***

Opportunities always increase in bear markets. ***Investors with a long view can take advantage of those driven by fear or liquidation pressure.*** Cheaper stock prices or greater clarity on the economic outlook should create a meaningful buying opportunity in risk assets in 2009. The history of markets, spanning as far back as the 1800s, includes numerous, sometimes lengthy periods of economic distress or malaise. It is important to remember that we not only survived all of them, but that meaningful investment opportunities emerged because of them.

**Finally, all of these represent general, not client specific tactics and strategies. One of our strengths as a firm is our ability to customize portfolios not just for the times, but for each client.**

**Given the current environment, we encourage all clients to be in touch to review their own personal situations, including risk profiles and investment time horizons.**