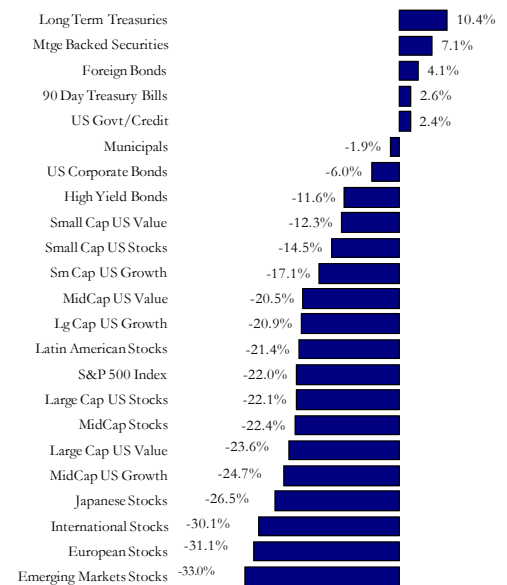


Historic. It's not often one word can summarize the activity of a single financial quarter, but it seems appropriate. The third quarter of 2008 was one of unprecedented changes in the U.S. market. U.S. consumers began to curtail their spending as tax rebate checks and their stimulus effects started to fade. It became increasingly difficult to obtain lines of credit to purchase homes, vehicles, and other goods as many financial institutions tightened their lending standards. With consumers increasingly finding themselves shut out of the market, existing homeowners and auto dealers had fewer buyers available. This resulted in more mortgage delinquencies and foreclosures, and more vehicles stuck on dealer lots. This continued to pressure auto manufacturers and further depressed home prices. As the unemployment rate continued to rise through the third quarter many Americans began to worry about their own job security and further reduced their spending.

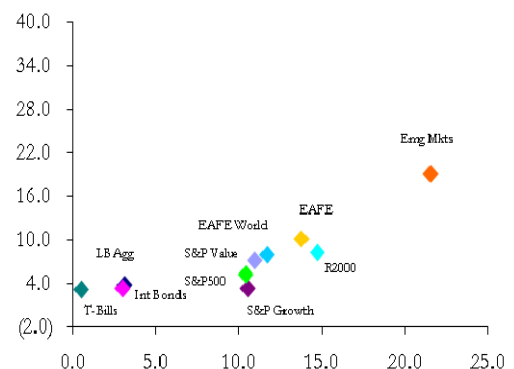
Credit market woes continued to lead the markets lower to start the third quarter. Leading the way this time were concerns over the financial strength of Fannie Mae, Freddie Mac and Lehman Brothers. Heightening concern was the collapse of IndyMac Bancorp and subsequent takeover by the FDIC. The Treasury attempted to address those concerns on September 7, when Treasury Secretary Henry Paulson announced that the government had seized control of Fannie Mae and Freddie Mac, both government-charter companies, thereby protecting more than \$5 trillion of debt and mortgage-backed securities owned by creditors. Secretary Paulson made it clear that equity investors, including preferred stock holders, were not considered in the (bailout) plans.

As momentous as it was, it almost paled in comparison to what was about to come. The market and economic activity leading up to the end of the quarter was nothing less than historic. Merrill Lynch, on the verge of collapse, was sold to Bank of America. Both Morgan Stanley and Goldman Sachs considered their options for survival, sought government support, and were refused. Rather than suffer the fate of Lehman Brothers, Morgan Stanley turned to foreign financing and Goldman Sachs chose to close its investment banking business. It is interesting to note that Goldman, now the fourth-largest bank holding company, was reportedly at the time of this writing in talks with the FDIC to purchase the assets of the aforementioned IndyMac Bank.

## One Year Performance of Asset Classes as of September 30, 2008



## Risk/Return Comparison of Asset Classes Five Years ended September 30, 2008



Data Sources: Zephyr StyleAdvisor & Lehman

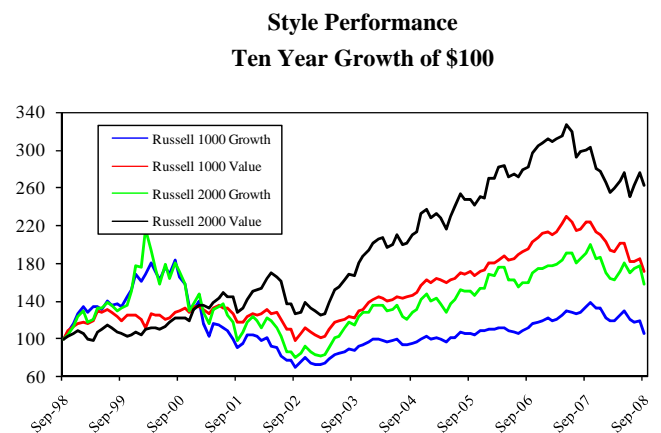
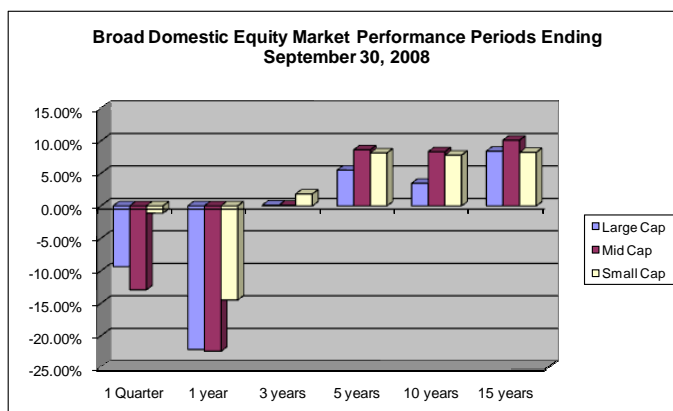
Data provided by sources believed to be reliable but no guarantee is made as to its accuracy. Past performance is no guarantee of future performance.

The current financial landscape was deemed in such disarray and so vulnerable to collapse that the Treasury and Congress felt compelled to step in and take action. Although the details were not known at the time of this publication, the Senate and Congress have enacted a financial “rescue” that could cost American taxpayers in excess of \$700 billion dollars. The exact details of the Emergency Economic Stabilization Act are not known, and may not be clear for some time. What is clear is that financially troubled homeowners will get some relief and the assets of some financial institutions will be supported in exchange for more government control and regulation.

Early third quarter domestic corporate earnings were reported largely in-line or slightly above expectations. However, many earnings forecasts were guided lower and the markets reacted to adjust to the lower guidance. Given this lower guidance, few third quarter announcements were a surprise. Of note, financials, having led the market lower for the previous three quarters started this quarter with positive news from JPMorgan. Although quarterly profits declined 52%, it did manage to beat expectations. This news was followed by Citigroup, also posting a loss for the quarter, but exceeding expectations. Bank of America’s second quarter income declined, but also beat expectations. This did little to calm the nerves of investors.

The global economic environment was not much better. European and Asian markets reflected the volatility in the U.S. The dollar was stable against the Yen, and gained strength against the Euro. European banks held rates steady again this quarter and continue to walk a fine line between inflation and the need to stabilize fragile economies.

Inflation in the U.K. accelerated to the fastest pace in 11 years. The U.K. is also facing its own housing slump and is struggling to avoid a recession. Inflation surged in Germany, Europe’s largest economy, and investor confidence dropped to a record low. In Japan, high commodity prices are dampening expansion. Japan raised its inflation estimates and cut its economic growth forecasts.



Data Sources: Zephyr StyleAdvisor & Lehman

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In the overall market, the month of September is historically the worst performing month of the year. September of 2008 proved to be no exception and furthermore was one of the most volatile ever. The month had four of the twenty largest point declines in the DJIA's history and three of the twenty largest point increases as the market took investors on a roller coaster ride. The ride continued right up through quarter's end with the DJIA losing 777.68 points on September 29th in the single largest point loss in the DJIA's history followed the next day (09/30) with a climb of 485.21 points in the second largest point gain of all time.

Looking at the major indices, the DJIA was down 3.71% for the quarter and is now in the midst of its longest quarterly losing streak (four) since 1977-78. Likewise, the Standard & Poor's 500 Index (S&P 500) extended its own four-quarter losing streak as a loss in the month of September of 9.1% pulled the index down 8.37% for the quarter and down 19.29% for the year. The Russell 3000 was down 8.73% for the quarter and is down 18.81% for the current year. The NASDAQ Composite also fell 9% for the quarter.

Sector returns in the S&P 500 were largely down for the quarter. Consumer Staples was the only sector to post a positive gain for the quarter as it rose 4.1% on the back of strong performance in Household and Personal Products subsectors. Energy & Materials were the big losers as Energy tumbled nearly 25% and Materials fell nearly 23%. Information Technology, Telecommunication Services, and Utilities also posted double-digit losses for the quarter while the Industrials sector was down over 9%. Remaining relatively stable for the quarter, Consumer Discretionary fell only 1% and Health Care was completely flat.

Surprisingly, the Financials sector was also relatively flat as it fell only 0.1% for the quarter, the sector's best performance since the second quarter of 2007. However, it should be noted that in looking at the subsectors in Financials, returns were considerably volatile. For the quarter in Financials, mammoth losses in Multi-line Insurance (down 62.8%) and Thrifts & Mortgage Finance (down 75%) were largely offset by the strength in Regional Banks (up 24.3%) & Other Diversified Financial Services (up 35.7%) giving an appearance of stability.

For market caps, small caps held steady as the Russell 2000 was down only 1.11% for the quarter, but remained down 10% for 2008 and 14.5% over the past year. Large-caps and Mid-caps had painful quarters as the Russell Top 200 was down 7.85%, the Russell 1000 was down 9.35%, and the Russell Midcap was down 12.91%. This left each of these three indices down 19.5% for 2008 and down 22% over the past year.

In comparing styles, value stocks outperformed growth stocks as the Russell 1000 Value fell 6.11% for the quarter compared to a decline of 12.33% for the Russell 1000 Growth. Similarly, the Russell 2000 Value rose for the quarter 4.96% while the Russell 2000 Growth fell 6.99%. As a whole, value stocks outperformed growth stocks by 6.67% in the quarter.

### **Commodities**

Commodity prices declined in the third quarter on expectations that the slowdown in the U.S. economy would lead to a worldwide slowdown and perhaps global recession. Coal, steel and copper were hit the hardest as decreased demands from China replenished previously tight supplies.

Oil dropped overnight by its largest percentage in 30 years after President Bush lifted the moratorium on drilling for oil and natural gas on the U.S Outer Continental Shelf. Oil prices declined to a 6 week low in July falling below \$125 per barrel. Gasoline inventories grew as American drivers logged fewer miles, but several hurricanes in the Gulf of Mexico forced platform and refinery shutdowns that fueled shortage fears and kept gasoline prices volatile at the pump. Oil continued to decline and by the end of September had settled in a narrow range between \$95 - \$105 per barrel.

### **Currency**

The U.S. dollar continued to strengthen against the Euro and Pound during the quarter as talks of a financial bailout by the U.S. government bolstered the dollar. The dollar was aided by the need for European governments to provide financial bailouts to several European banks. Additionally, there are concerns that a weakening European economy could force economic leaders to lower interest rates despite inflationary fears putting further pressure on the Euro.

*Data Sources: Zephyr StyleAdvisor & Lehman*

*Data provided by sources believed to be reliable but no guarantee is made as to its accuracy. Past performance is no guarantee of future performance.*

As with most sectors of the economy, fixed income markets saw immense activity during the third quarter. Banks were taken over, mortgage lenders were bailed out, short term treasury securities were at times yielding near 0.00%, the U.S. Treasury Department announced a plan to buy certain mortgage backed securities, and ratings agencies were once again in the spotlight. Put bluntly, it was an incredibly busy quarter.

To begin the quarter, Countrywide Financial's mortgage portfolio was taken over by Bank of America, prompting Moody's and Standard & Poor's to upgrade the senior debt ratings to Aa2 and AA respectively, despite their negative outlook. The upgrade paired the debt ratings of Countrywide's mortgage portfolio to that of Bank of America's.

By mid July, both Moody's and S&P were downgrading Fannie Mae and Freddie Mac debt over concerns that capital holdings were falling despite plans to raise billions in additional capital.

In early September, Henry Paulson announced a bailout plan for Fannie Mae and Freddie Mac, pledging up to \$100 billion to prop up the mortgage giants. Henry Paulson referred to the mortgage lender rescue plan as his "bazooka" option, hoping it would create enough confidence to calm down fixed income markets. Many strategists believed the Fannie and Freddie bailout would finally provide downside relief as markets continued to unwind near the end of the third quarter.

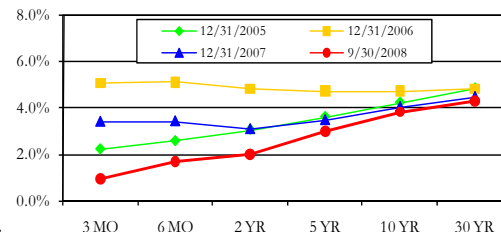
AIG was another institution that was granted a government bailout package of \$85 billion in September. On the heels of the Lehman Brothers failure, AIG's presence in the credit default swap marketplace caused its value to steadily fall as other fixed income and real estate investments failed. By September 30th, AIG had already spent \$61 billion of their \$85 billion bailout.

As the credit crisis continued to expand, some money market funds were forced to "break the buck" and price their shares below the standard \$1.00 per share. Some money market funds had exposure to Lehman Brothers debt: the most notable example was Reserve Management's \$65 billion Primary Fund. The fear of further money market losses triggered more than \$170 billion in money market fund withdrawals during a seven day stretch in mid September. During that same period, more than \$60 billion was moved to government money funds, seeking the federal guarantee of treasury bonds as a safe haven. At the end of the third quarter, the Treasury announced an insurance program for money market funds that seems to have halted the massive withdrawals.

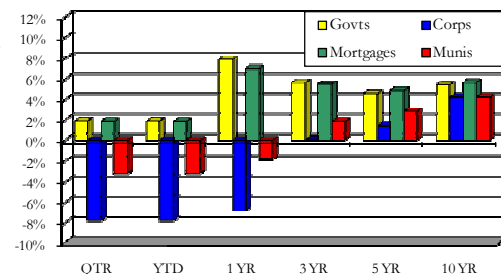
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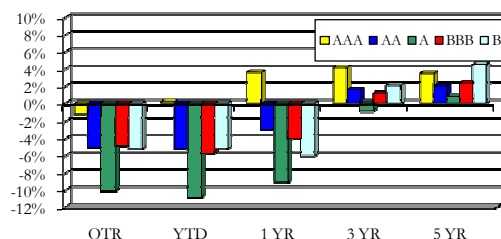
**Treasury Yield Curve**



**Sector Performance**



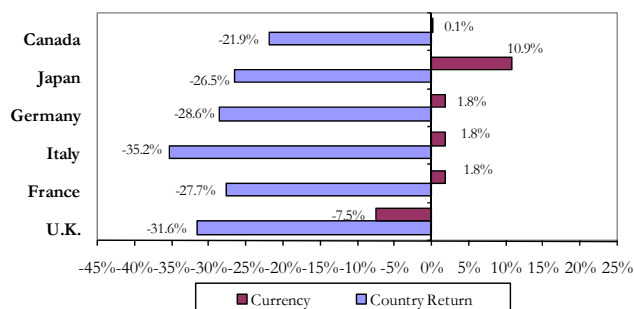
**Credit Performance**



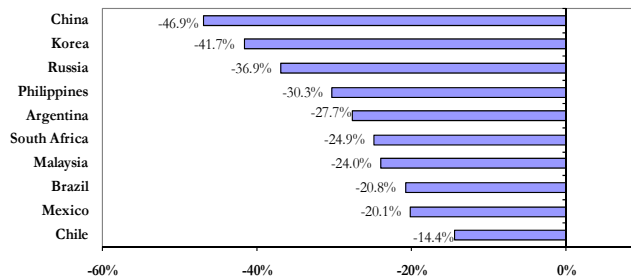
The financial crisis that paralyzed many large US firms has spread in full force to foreign markets as banks across Europe have been bailed out or nationalized by their respective governments in the closing weeks of the third quarter. The European banking system ended the quarter in turmoil as the European Union is attempting to reconcile the many governments that currently hold the charge of regulating the financial institutions within their borders. Ireland's government went as far as to say it was guaranteeing all bank deposits at Irish banks for the next two years. This action has resulted in controversy as there have been some flows of deposits to Irish banks from the neighboring United Kingdom. Japan's banks, however, appear to be in a much stronger position thanks to conservative balance sheets. Despite this fact, shares of Japanese companies fell in the third quarter as the MSCI Japan index dropped 18.3% over the three month period. The MSCI EAFE Index finished the third quarter of 2008 down 20.6% and has lost just over 30% of its value in the past 12 months. In contrast, part of the underperformance of foreign stocks in the third quarter can be attributed to a strengthening dollar.

Emerging markets stocks declined further in the third quarter than markets in developed countries. The MSCI Emerging Markets Index was down 27.6% for the quarter and posted a loss of nearly 35% over the past 12 months. Russia's performance, as measured by the MSCI Russia Index, was particularly bad, losing almost 24% in September to close the quarter down 45.4%. Russia's markets were hampered by dropping commodity prices as well as the conflict in Georgia which ironically began just as the Olympics, a symbol of international unity, commenced in Beijing, China. Trading on Russia's stock exchanges was suspended multiple times in September as losses mounted and US investors pulled money away from foreign stocks. While Russia may have been the country hit hardest, emerging markets in every region performed poorly with Emerging Asia, Europe, and Latin America falling 24%, 36.3%, and 32.9% during the quarter, respectively.

**One Year Country and Currency Returns  
G-7 Excluding U.S. as of September 30, 2008**



**One Year Emerging Market Country Returns  
As of September 30, 2008**



Data Sources: Zephyr StyleAdvisor, MSCI, S&P/Citigroup

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