Kalorama Wealth Strategies

A Beautiful View To Your Financial Future℠

David M. Taube, CPA, CFA, CFP®, CRI
Founder and President

2136 12th Place, N.W., Suite 100
Washington, D.C. 20009-7507

Phone: 202.550.7262
Fax: 480.247.5620

dtaube@kaloramawealth.com
www.kaloramawealth.com

Fourth-Quarter 2008 Market Review ~ Volatility & Words of Financial Wisdom

January 2009 - Stocks were pummeled in the fourth quarter of 2008 as credit markets remained frozen in the wake of the mid-September Lehman Brothers Holdings Inc. bankruptcy, overall concern about financial institutions, and a bleak outlook for the economy. Major market barometers swooned in October, were moderately negative in November, and essentially flat in December. Although credit markets thawed a bit in the latter part of the quarter, market indicators posted their worst losses in decades.

There was virtually nowhere to hide in stock markets during the quarter. All indices had double-digit declines, with Real Estate at the bottom of the barrel, tumbling 32.3%. The "best" performing equity asset class was International Large Cap, shedding 19.9%. With U.S. Treasury securities providing investors a safe haven, broad bond indices rallied during the quarter. The opposite occurred in the riskier fixed-income sectors, with High Yield Corporate Bonds unloading 17.9% and Emerging Market Bonds retreating 9.3%.

After months of weakening consumer spending, home sales, and employment, on December 1st, the Business Cycle Dating Committee of the National Bureau of Economic Research (NBER) declared the U.S. economy to be in recession beginning in December 2007. In response to deteriorating economic conditions and unmoving credit markets, at the beginning of October, in a coordinated global effort with six other central banks, the Federal Reserve cut the Fed Funds rate by 50 basis points to 1.50%. The Fed then cut the rate by another 50 basis points to 1.0% at the end of October and to a target range of zero to 0.25% at its mid-December meeting, the lowest level since recordkeeping began.

In its December rate announcement, the Fed pledged to keep rates low as long as economic conditions warranted and to use "all available tools" to combat the severe financial crises. During the quarter, the Fed and Treasury also announced they would create facilities to provide liquidity for residential mortgage-backed securities, as well as automobile and credit card asset-backed securities.

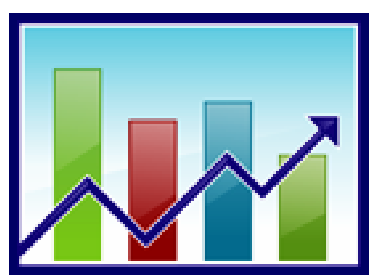
At the same time, a massive flight to quality pushed the yield on one- and three-month Treasury Bills to near and at some points below zero, demonstrating that investors are willing to earn little or negative returns in exchange for the safety of U.S. Government Bonds. During the quarter, the 10-year Treasury Note traded below 2.10%, and at quarter end the yield had sunk 160 basis points to close at 2.22% (the yield as of January 12th was 2.31%).

Below are rates of return for selected market indices for the fourth quarter of 2008, full-year 2008, and the three, five, and 10-year compound annual returns as of December 31, 2008.

	4Q:2008	2008	3-Year	5-Year	10-Year
Equity (Stock) Indices					
Domestic Large Cap					
Russell 1000 - Growth	-22.79%	-38.44%	-9.11%	-3.42%	-4.27%
Russell 1000 - Value	-22.18%	-36.85%	-8.32%	-0.79%	1.36%
Russell 1000 - Blend	-22.48%	-37.60%	-8.66%	-2.04%	-1.09%
Domestic Small Cap					
Russell 2000 - Growth	-27.45%	-38.54%	-9.32%	-2.35%	-0.76%
Russell 2000 - Value	-24.89%	-28.92%	-7.49%	0.27%	6.11%
Russell 2000 - Blend	-26.12%	-33.79%	-8.28%	-0.93%	3.02%
Real Estate (FTSE EPRA/NAREIT Global)	-32.38%	-47.72%	-11.53%	1.96%	6.57%
International					
MSCI EAFE Developed Large Cap	-19.90%	-43.06%	-6.92%	2.10%	1.18%
MSCI EAFE Developed Small Cap	-22.11%	-46.78%	-13.45%	1.51%	NA
MSCI Emerging Markets	-27.56%	-53.18%	-4.62%	8.02%	9.31%
Fixed-Income (Bond) Indices					
Lehman Brothers					
Global Aggregate	5.25%	4.79%	6.95%	5.01%	5.22%
U.S. Aggregate	4.58%	5.24%	5.51%	4.65%	5.63%
U.S. Treasury TIPs	-3.48%	-2.35%	3.06%	4.07%	6.79%
U.S. Corporate High Yield	-17.88%	-26.16%	-5.60%	-0.80%	2.17%
Municipal	0.74%	-2.47%	1.86%	2.71%	4.26%
International Emerging Markets	-9.31%	-14.75%	-0.46%	4.38%	9.62%

Source: www.russell.com, www.nareit.com, www.mscibarra.com, www.lehman.com

Volatility

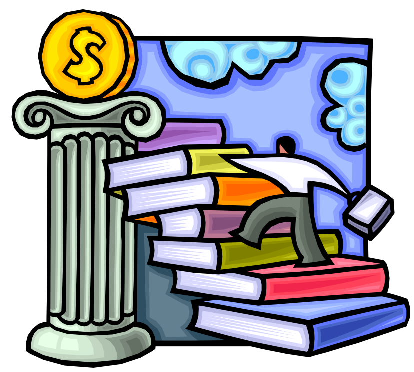


In 2008, global financial markets exhibited exceptionally high levels of volatility as banks, securities firms, and insurance companies began to de-leverage their balance sheets, and governments took actions to unclog credit markets. With market bellwethers suffering their worst losses since the 1930s, the market turmoil left essentially no asset class untouched. With the exception of most government bonds, all major asset classes plummeted by multiple digits. Equities took the brunt of the backslide with domestic and international stocks shrinking by nearly 30% to more than 50%.

Most of the year's carnage occurred between September 15th (the day the Lehman Brothers bankruptcy and Merrill Lynch's takeover by Bank of America were announced) and December 1st. During this period, stock markets experienced huge one-day percentage moves and intra-day swings equal to returns most investors would be happy with on an annual basis. There were 55 stock market trading days, of which 22 were up and 33 were down, as measured by the Dow Jones Industrial Average. On October 13th, the Dow Jones had its largest surge, soaring 11.1% on the heels of eight consecutive daily losses with a cumulative melt-down of more than 22%. Two days later it sank 7.9%, the biggest dip for the interval.

The market fluctuations throughout this stretch were seemingly unparalleled. The average daily percentage change for the 30-stock Dow Jones was a whopping 3.6%, while the movement for the Standard & Poor's 500-Stock Index averaged 3.8%, demonstrating the widespread nature of the market bloodbath. There were only seven days in which the Dow Jones moved less than 1.0%. For all of 2008, the average daily percentage change for the market bellwether was 1.63%. Putting this into perspective, prior to 2008 there have only been three years since the 1930s when the average daily change has surpassed 1.0%: 1974, 1987, and 2000; the average for 2001 was 0.9934% (*Stocks for the Long Run*, Jeremy Siegel). Ironically, the big variations seemed to have mostly disappeared after the NBER confirmed on December 1st that the economy is in recession, the day on which the Dow Jones plunged 7.7%.

Words of Financial Wisdom



In the midst of October's market commotion, several well-known investment luminaries expressed their opinion that they are finding compelling opportunities in the current market. Opining in the October 16, 2008 editorial pages of *The New York Times*, Warren Buffett, the chief executive of diversified holding company Berkshire Hathaway, revealed that he is buying U.S. stocks for his personal account. Dubbed the "Oracle of Omaha" because of his investment acumen and distinction of being the second-richest person in the world, he provided a simple rule which influences his buying: "Be fearful when others are greedy, and be greedy when others are fearful." (See http://www.nytimes.com/2008/10/17/opinion/17buffett.html?_r=1&oref=slogin for the entire Op-Ed.)

In an October 11th, *New York Times* article, "Those With a Sense of History May Find It's Time to Invest," several investors and economists commented on the fear and panic gripping financial markets. Long-time value investor Martin Whitman summed it up by saying: "This is the opportunity of a lifetime. The most important securities are being given away." (See http://www.nytimes.com/2008/10/12/business/12stox.html?_r=1&scp=2&sq=whitman&st=cse&oref=slogin for the entire article.)

So, where are we now relative to the high and low points? The Dow Jones and the S&P 500 hit their all-time highs on October 9th, 2007, closing at 14,164.53 and 1,565.15, respectively. Finishing 2008 at 8,776.39 and 903.25, the Dow Jones and the S&P 500 had jettisoned 38.0% and 42.3%, respectively, qualifying for the "bear market" moniker. In the meantime, as of year end, the Dow Jones and S&P 500 had rebounded 16.2% and 20.0%, respectively, from their closing lows of 7552.29 and 752.44 on November 20th.

Meanwhile, stocks appear to be inexpensive based on fundamentals such as earnings and cash flow, with the S&P 500 selling at 11 times estimated operating profits for 2009, compared with an average operating earnings multiple of 19 since the end of 1988. Moreover, according to a January 4, 2009, *Bloomberg News* article, "Cash Glut Could Take Markets on a Ride," there is more cash on the sidelines available to invest than at any time in almost twenty years. The $8.85 trillion of so-called "money of zero maturity" (cash, bank

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deposits, and money-market fund assets available for immediate spending) equals 74% of the market value of U.S. companies, the highest ratio since 1990 when it last peaked at 75%. (See http://www.washingtonpost.com/wp-dyn/content/article/2009/01/03/AR2009010300027.html for the entire article.)

The market fluctuations and price declines have not been for the faint of heart; portfolio losses have been horrendous. As we discussed in October's newsletter, don't panic; although past performance does not guarantee future results, historically all bear markets have come to an end and have been followed by a recovery. Also, you should stick to your long-term strategy. Continue contributing to your retirement or other accounts, and maintain a well-diversified portfolio which is periodically rebalanced to make sure the asset allocation is consistent with your risk tolerance.

If you are not sure whether your portfolio is adequately structured to benefit from a future recovery, Kalorama Wealth Strategies can help you create an investment plan to achieve your financial goals. For more information, please see our web site at www.kaloramawealth.com.

Thank you for your business, trust, and referrals. Please feel free to provide a copy of this newsletter to friends and colleagues who can benefit from information about investing and financial planning. If I can be of any assistance to you or anyone you know, please do not hesitate to contact me.

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David M. Taube, CPA, CFA, CFP®, CRI
2136 12th Place, N.W., Suite 100, Washington, D.C. 20009
Phone: (202) 550-7262 Fax: (480) 247-5620
dtaube@kaloramawealth.com www.kaloramawealth.com