



### Financial Review

Equity markets finished 2008 with the third worst annual loss in history. The S&P 500 Index declined 37% for the year, while international and emerging markets suffered greater losses, with most benchmarks down 40% to 60%.

The near collapse of the global financial system in September/October resulted in virtually all participants seeking liquidity and safety. As a result, money flowed out of all asset classes – with the notable exception of U.S. Treasury securities. With the mindset of risk avoidance, investors treated all risk asset classes similarly (regardless of price). We believe the general psychology of the market in the new year will evolve from risk-avoidance to risk-aversion. With so much money tied up in cash or short-term treasuries, investors will eventually move this hoard toward assets offering modest reward for modest risk.

One area where this modest risk-taking will be seen is the corporate bond market. Yields on corporate bonds spiked in September as the bankruptcy of Lehman Brothers spooked investors. In the fourth quarter, spreads on corporate bonds (i.e. the yield difference between a corporate bond and treasury bond) widened to historically high levels due to expectations for a deep economic recession.

At recent yields, the corporate bond market is factoring default rates in excess of those experienced in the Great Depression. Our view is these spreads will narrow as investors see the attractive return opportunity compared with the microscopic yields on treasuries. BBB rated (investment grade rated

bonds that are one notch below A rated bonds) corporate bonds presently offer an especially attractive investment opportunity, as spreads are 200-300 basis points higher than normal. It appears that we are witnessing a thawing in these segments of the market, as spreads have already begun to narrow in January.

What will take longer to heal is the broader stock market. After the magnitude of losses in stocks last year, investors will likely be slow to re-allocate assets from “safe” investments toward equities. In 2009, we believe the stock market will be range-bound for at least the first half of the year, as investors alternate between the optimism of the economic effect of massive stimulus pumped into the economy, offset in part by what will likely be grim economic and employment data.

The Obama administration is effectively dampening expectations that their stimulus plan will provide a quick fix for the economy. In order to be successful, the stimulus plan must create jobs to help offset labor declines in the private sector. Even if the plan is approved by mid-February, it is unlikely that any meaningful results from the stimulus will be seen at least until late summer. Our view is the most important precursor to a new “bull” market is stability in the employment ranks. At this time, it is too early to tell when the labor data will reach an inflection point, but it is important to note that corporations were more aggressive in layoffs at the onset of the economic slowdown than in prior recessions. It is possible we will see a slowdown in layoffs in the second quarter – an event that would likely be viewed quite favorably by the stock

market. We will be monitoring the labor market closely as the key determinant for the stabilization and, hopefully, the eventual rebound in the economy.

Despite the uncertain near-term outlook for the broader market, we believe the decline in stock prices has created new opportunities in strong companies that have been punished equally to their weaker competitors. The recent economic dislocation will force struggling, poorly-run enterprises to take drastic actions to survive, while their competitors with greater financial and operational flexibility will be positioned to capitalize. Financial strength and the ability to grow market share will be attributes rewarded over the next 18-24 months. Our Core stock portfolios are - and will be - positioned accordingly.

---

## Core Equity Portfolio

During the quarter, we initiated positions in Honeywell and Mosaic.

Honeywell is a diversified technology and manufacturing company, providing aerospace products and services, control technologies, and power generation systems. Although Honeywell's businesses have been - and will continue to be - impacted by the economic slowdown, management has been preparing for an economic slowdown for the past 3 years - restructuring its business portfolio by expanding globally, while at the same time selling weaker divisions. At the time of purchase, the stock price was particularly depressed in part due to a long union strike at Boeing (which has been resolved), impacting all aerospace/defense companies. With a stock price valuing the company at less than 10 times reduced earnings - and a solid dividend yield of 3.7% - we believe investors will be

paid well pending an upturn in Honeywell's businesses.

Mosaic is a leading producer and distributor of fertilizer products. Global demand for products designed to improve crop production led to rapid growth in Mosaic's fertilizer related businesses. Recently, concerns over reduced fertilizer output have resulted in the share price of Mosaic to be down 75% from its highs. Trading at less than 5 times reduced earnings, and with zero net debt on its balance sheet, the market is valuing Mosaic as if demand for fertilizer products is in permanent decline - an unlikely scenario in our opinion.

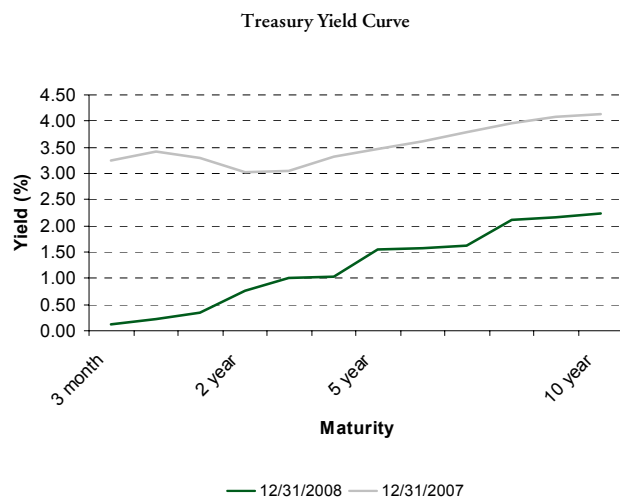
In the fourth quarter, we sold our holding in Colgate-Palmolive, a leading provider of consumer products. We originally initiated our position in Colgate in 2006 as the company was positioned for accelerating revenue growth due to new product introductions. Since our purchase, Colgate has successfully grown revenues and profits from their enhanced product portfolio and disciplined expense management. With much of this success reflected in Colgate's stock price, we decided to eliminate our position in part to pursue new opportunities in the companies mentioned above.

Although the outlook for the broader market is quite uncertain, we believe 2009 will be a year in which the market will distinguish strong companies (and industries) from the weaker ones. Companies demonstrating the ability to maintain and grow market share in a faltering economy will be rewarded, as will the investors willing to commit capital in the belief that an economic recovery will eventually occur.

December 31, 2008

## Fixed Income Markets

The continued flight to safety resulted in a strong rally in the price of U.S. Treasury securities, sending yields across the curve to new lows. The yield for benchmark 10-year treasury dropped more than 160 basis points in the quarter to finish the year at 2.23%. Investors aversion to risk was even more evident in the short end of the yield curve, with t-bills sporting yields near zero.



The rally in treasury securities was not fully reflected in other taxable bond securities, resulting in widening spreads. Corporate bond yields, in particular, have seen spreads widen to levels more than twice the historical norm. As noted above, investment grade corporate bonds represent tremendous value today in the taxable bond universe.

Prices for municipal bonds improved slightly in the quarter, but still remain well above traditional levels when compared to treasuries. Many state and local governments are facing budget strains as tax revenues decline from slowing economic activity. In this environment, we are taking a very cautious approach to municipal bond portfolios,

placing greater emphasis on the highest quality credits as well as bonds with maturities that are pre-refunded. We prefer giving up some yield in order to enhance preservation of principal.

## Alternative Investments

There is no definitive source on the amount of deleveraging that occurred last year within Alternative Investments, but GFIA, a hedge fund consultancy, estimates the market had \$6 trillion in capital and held \$24 trillion of assets at the beginning of last year (4x leverage). By year-end, losses had reduced capital to under \$3 trillion and leverage had been reduced to 1.5x, resulting in \$4 trillion of assets being held. This is an astonishing 80% implosion in assets.

We expect this to result in outstanding opportunities for **Long Credit** and **Distressed Debt** strategies. First lien debt is now yielding 14%-18%, compared with 6%-8% a year ago. Default rates would need to double the historical highs seen in past recessions and recoveries would need to be 1/3 less for investors to lose money from current prices. The risk/reward appears strongly favorable.

**Merger Arbitrage** spreads are at their widest level in the last decade. Even well-capitalized, all cash deals are being called off under the pretext of economic weakness at the target company. The more likely reason for terminating the agreement is that the sell-off in the equity markets makes the transaction too expensive today. Renegotiated and newly announced deals offer some of the best opportunities in several years.

December 31, 2008

Looking forward, we believe many **Long-Short** hedge funds will continue to struggle. Investors are demanding to know why a less liquid, higher cost vehicle is required for a specific investment opportunity; many long-short managers will fail to meet this higher hurdle. In anticipation of this structural change, we exited many of our traditional long-short funds last year. We believe our current managers will enjoy a market with lower valuations for longs, less expensive and easier located sources of stock for shorts, and a less competitive research environment.

Traditionally, **Private Equity** managers have held investments "at cost" until an event resulted in an upward or downward adjustment. New guidelines on the FASB 157 accounting rule took effect in 2008, however, and managers are now required to mark their current holdings to a value that they believe could be obtained if the asset were sold today. We expect many private investments to be at least temporarily written down, even if operating results have performed in-line with expectations. This new layer of volatility to private equity returns will result in a greater focus on those managers able to bring operational improvements to smaller firms with less leverage.

### One Year Economic Overview

		Dec 2008	Dec 2007
<b>Stock Market</b>			
S&P 500 Index	▼	903.25	1,468.36
Russell 2000 Index	▼	499.45	766.03
<b>Fixed Income Yields</b>			
3-Month Treasuries	▼	0.12%	3.25%
5-Year Treasuries	▼	1.54	3.46
10-Year Treasuries	▼	2.23	4.14
30-Year Treasuries	▼	2.66	4.46
<b>Inflation Monitor</b>			
CPI-Trailing 12-Month Growth	▼	0.1%	4.3%
CPI-(Excluding Food/Energy)	▼	1.8	2.3
Market Expectations*	▼	0.0	2.1
Gold (per ounce)	▲	\$882.05	\$833.92
Crude Oil (per barrel)	▼	44.60	96.00

\*Comparison of yields for 10-Year Treasury and 10-Year TIPS

## Final Notes

If you would like to receive important communications from us via email, please send your request to [debby.frenzel@cedhill.com](mailto:debby.frenzel@cedhill.com)