

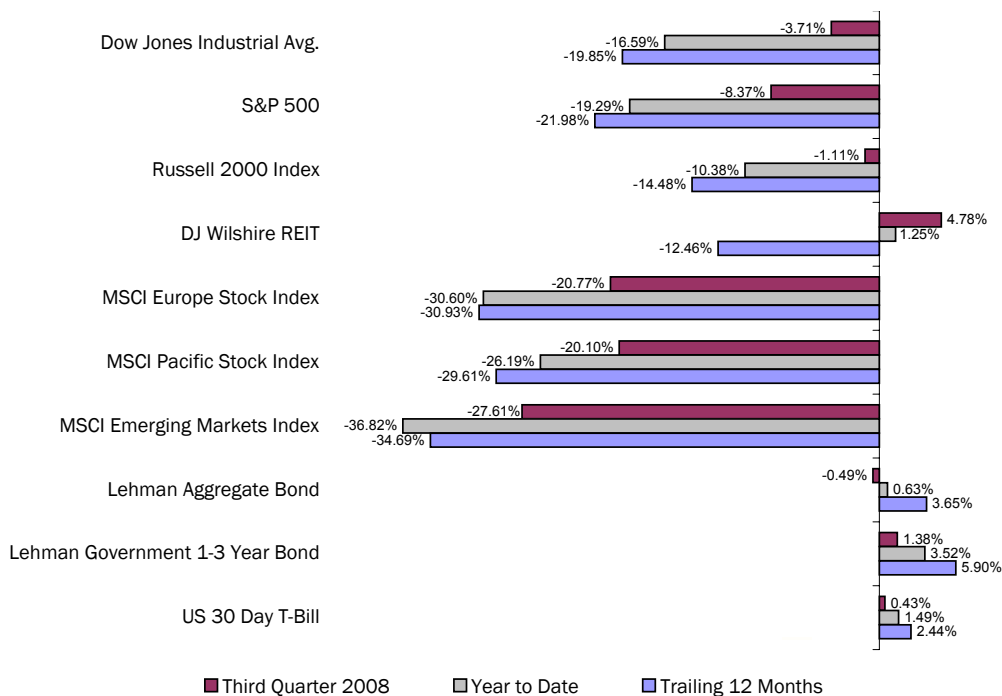
## WORLD MARKET SURVEY

### Blood on the Street

Markets were mostly flat through most of the third quarter, despite increasing awareness of problems with mortgage-backed securities. But in mid-September, markets headed sharply south in what has since developed into the most serious bear market since 1929. The Dow Jones Industrial Average was down 3.7% for the quarter, and the broader S&P 500 Index was down 8.4%. The Dow has fallen 19.9% in the twelve months ending September 30, and the S&P 500 has plummeted 22.0%. After one of the bloodiest quarters ever (we withhold judgement on Q4, which is after all just getting started), the talk is no longer of whether we are in a bear market, but of whether we should brace for another Great Depression.

(continued on page 8)

**Index Returns: Third Quarter 2008, Year-to-Date, & Trailing 12 Months**



## ECONOMICS, RECESSIONS AND THE STOCK MARKET: AN OVERVIEW OF “THE DISMAL SCIENCE”

Economics, technically defined as “the study of the allocation of scarce resources”, is often referred to in academic circles as “the dismal science.” There may be multiple reasons for this derisive moniker. Any discipline that inherently presumes that there will never be enough to go around (“scarce resources”) deserves to be perceived as having a negative slant. But perhaps more importantly, while economists seem to do a reasonably decent job of explaining what has happened in the past, they are less successful predicting what is likely to happen in the future, and are not consistently able to recommend timely policy adjustments to avoid negative future outcomes – e.g., recommending a

fiscal stimulus package to help avoid a predicted recession.

One of the difficulties economists face when trying to predict and manage future economic conditions is the significant time lag necessary to collect accurate data about current economic conditions. The study of overall economic conditions – called macroeconomics – relies on the analysis of literally hundreds of data points, such as employment statistics, inflation metrics, exports and imports, property values, interest rates and business and consumer confidence. Gathering these data takes months, and the data are always subject to revision, sometimes a

year or more after their initial publication. Some – such as consumer confidence – are based on subjective survey criteria. While macroeconomic models are useful for compiling and analyzing all these data, the relative importance of different factors changes from period to period. Consequently, a model that successfully predicted economic conditions last year may be wildly inaccurate this year.

### Macroeconomic Forecasts and Economic Stimulus

Understanding the uncertainties surrounding macroeconomic forecasting and management of the aggregate economy helps frame much of the current

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*Without a generally accepted definition for the term “recession”, it’s not surprising that economists disagree about whether or not the economy is in a recession.*

debate about the US economic situation. It also helps explain why the stock market has dropped precipitously over the past year. Beginning in mid 2007, many economists argued that the combination of rapidly rising energy and commodities prices, and the housing slump and related credit crisis, would push the US economy into recession in late 2007 or early 2008. By late 2007, some economists argued that the US economy was already in recession, while others believed we were simply in a period of slowing growth. Both camps could point to some data supporting their position, but due to timing lags, imprecise data collection, and different macroeconomic models, a year later, it is still not possible to determine which side was right. In any event, the situation was perceived to be sufficiently dire that Congress and the Administration rapidly pushed through an economic stimulus package, seeking to jumpstart the economy by distributing tax rebate checks intended to boost consumer spending. These checks went out during the second quarter of 2008, and based on preliminary numbers, appear to have helped improve second quarter economic performance.

Economists continue to debate both the state of the economy and the impact of the economic stimulus package. Optimists argue that the economy is not in recession, and that the stimulus package will help us avoid a recession in the near future. Pessimists argue that we were already in recession when the stimulus checks went out, that the stimulus was insufficient to jumpstart the economy and primarily served to increase an already enormous Federal budget deficit, and that at best, second quarter economic performance represents a temporary upward blip in a generally downward economic trend. Since we cannot access current, accurate, economic statistics, and since we don’t fully understand how stimulus packages affect the economy, we don’t know whether the optimists or pessimists are right. By the time accurate economic data are available, it will be too late for them to be useful. Economics truly is the dismal science!

### Defining “Recession”

Further confusing the situation, economists don’t even agree about the true definition of recession. The online resource Wikipedia presents the mainstream definition of recession as “a

decline in any country’s Gross Domestic Product (GDP), or negative real economic growth, for two or more successive quarters of a year.” However, the National Bureau of Economic Research (NBER), which is the official arbiter of US recessions, defines a recession as “a significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in real GDP, real income, employment, industrial production, and wholesale-retail sales.” The Wikipedia definition is objective, relatively easy to apply, and dependent on a single statistic. The NBER definition is subjective, more difficult to apply, and based on analysis of many statistics. Without a generally accepted definition for the term “recession”, it’s not surprising that economists disagree about whether or not the economy is in a recession.

### Recessions, the Stock Market, and Discount Factors

How does stock market performance relate to economic performance and recessions? To begin to answer this question, it’s helpful to consider what you are really purchasing when you buy a stock. The value underlying any stock derives primarily from future profits expected to be generated by the company issuing the stock. As a stockholder, you own a partial interest (a “share”) in those future expected profits. To properly value the stock, you need to discount the future profits by a time factor (profits earned far in the future are less valuable than profits earned this year) and a risk factor (profits that are guaranteed are more valuable than expected profits that are highly uncertain).

Since recessions represent slowing economic activity, they typically make it more difficult for companies to generate profits. From an investor’s perspective, if no recession is forecast, a given company may be expected to generate both current and future profits with a relatively high degree of certainty. However, if economic forecasts change and a recession is predicted, the same company may not generate current profits, and future profitability may be less certain. All else equal, then, the onset of a recession makes a company’s stock less valuable, because both time and risk factors represent larger discounts on future profits under a recessionary scenario.

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[Tangentially, recessionary forecasts have different effects on different types of stocks. Some companies (e.g., food manufacturers) make products that we need to buy regardless of economic conditions. Other companies (e.g., jewelers) make products that we are more likely to buy when times are good. When a recession is forecast, money managers may shift investments out of stocks (such as jewelers) that are expected to be disproportionately hit by the recession, in favor of stocks (such as food manufacturers) that are expected to hold up relatively well. In this example, food manufacturers might forecast lower profits, but still see their stock price rise, due to increased demand for their stock attributable to the recessionary forecast.]

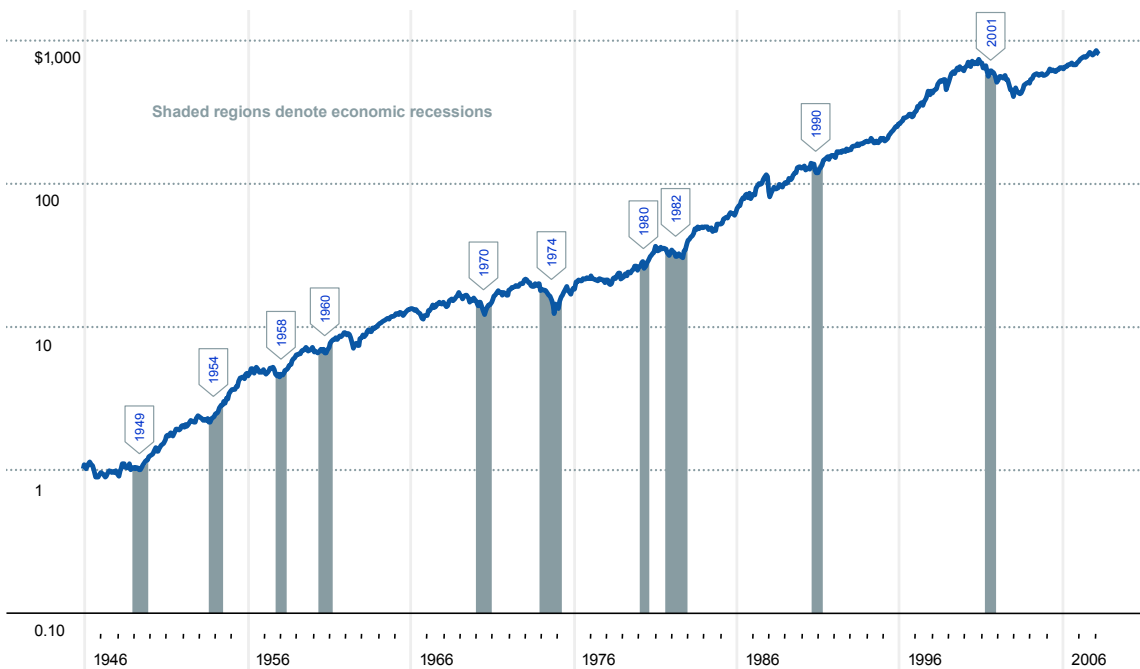
The stock market performs this discounting function on a forward-looking basis. Larger discounts aren't applied when the economy is already in recession (remember, it may take literally years for economists to agree on when we are in recession); rather, larger discounts apply when the prospect of recession is perceived to be more likely by investors. For this reason, the stock market is described as a leading economic

indicator — the stock market forecasts the future direction of the economy. When the stock market is strong, future economic conditions are likely to be healthy, and, when it slumps, recessions are more likely. Some studies conclude that a review of recent stock market performance may be a more accurate predictor of future economic activity than consensus forecasts prepared by economists.

Consider Chart 1, reporting stock market performance through time, with the gray bars representing official periods of US economic recession. A close review of stock market performance illustrates a downward trend (i.e., stock market losses) prior to the start of every recession measured since 1946. Similarly, during virtually every recessionary period, the stock market begins an upward trend prior to the end of the recession (the 2000-2002 bear market continued even after the 2001 recession ended). The 1954 recession is particularly interesting. The post-recession stock market recovery begins before the recession officially starts. The stock market does in fact appear to be a leading economic indicator!

*The stock market is described as a leading economic indicator — the stock market forecasts the future direction of the economy.*

Chart 1: Stock Market During Recessions (1946 - 2007)



• **Past performance is no guarantee of future results.** Hypothetical value of \$1 invested at the beginning of 1946. Assumes reinvestment of income and no transaction costs or taxes. This is for illustrative purposes only and not indicative of any investment. An investment cannot be made directly in an index. © 2008 Morningstar, Inc. All rights reserved. 3/1/2008

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### Large and Small Stocks after Recessions

As we noted previously, recessionary forecasts have different effects on different types of stocks. In particular, small cap stocks tend to experience larger losses than large cap stocks ahead of a recession. Part of this larger loss is attributable to the expectation that small caps generally have greater future profit growth potential than large caps. Future profits are discounted more severely than current profits. Additionally, while large cap companies will generally survive recessions, albeit in a diminished capacity, severe recessions permanently eliminate many small cap companies (either through bankruptcy or acquisition).

Conversely, while stocks in general tend to do quite well coming out of recessions, small caps tend to perform even better than their large cap counterparts. Chart 2 illustrates the relative performance of large and small cap stocks following the official end of a recession (please note that the three year numbers represent cumulative, not annualized, returns).

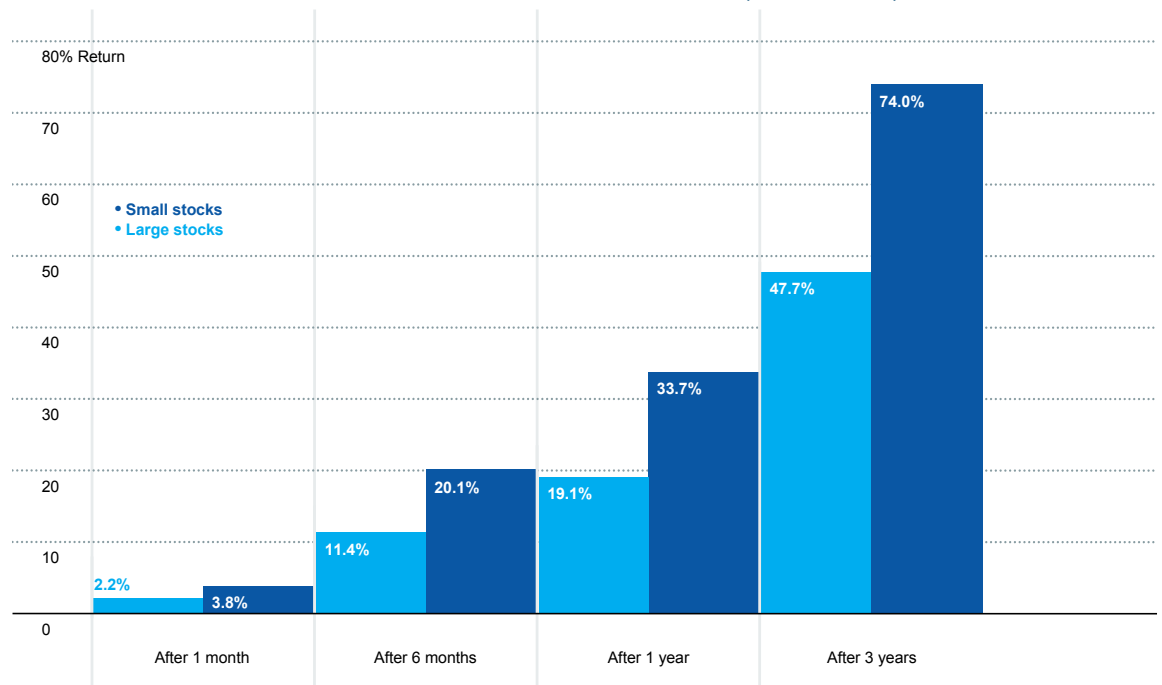
The long term average return from large cap stocks is approximately 10%/year, and the long term average return from small cap stocks is approximately 12%/year. Average returns from large cap stocks in the year following the end of a recession are nearly double the long term average, and average returns from small cap stocks are nearly triple their long term average.

### Using the Stock Market to Forecast What to Expect Next

Has the US economy been in recession in 2008? While many politicians, and pundits, and some economists think that it is, the NBER has not yet officially reported a recession, and may not report one at all. But looking back at Chart 1, we see various clues that at least one leading economic indicator (the stock market) was forecasting a recession in 2008. First, simply looking at the relative frequency of recessions (the grey bars), which traditionally mark the beginning and end of business cycles, we appeared to be due for a recession. The chart indicates eight official recessions between 1946 and 1982 (an

*Small cap stocks tend to experience larger losses than large cap stocks ahead of a recession.*

Chart 2: Stock Market After Recessions (1945 - 2007)



• **Past performance is no guarantee of future results.** Cumulative returns of large and small stocks after recessions 1945–2007. This is for illustrative purposes only and not indicative of any investment. An investment cannot be made directly in an index. © 2008 Morningstar, Inc. All rights reserved. 3/1/2008

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average business cycle of 4.5 years), but only two recessions between 1983 and 2007 (an average business cycle of 12 years). Furthermore, the stock market downturn which began in October 2007 could be seen as indicative of an increased possibility of recession. Finally, small cap stocks underperformed large cap stocks in 2007: the small cap oriented Russell 2000 Index dropped 1.6%, while the large cap S&P 500 gained 5.5%), reversing a pattern of small cap leadership that had persisted over most of the prior seven years. Separately, each of these market indicators has little import, but taken together, they may indicate that during 2007, the aggregate stock market perceived an increased risk of recession in 2008.

What messages might we derive from more recent market performance? While the period is very brief, during the third quarter of 2008, small cap stocks generally outperformed large caps. During the third quarter, the small cap Russell 2000 index dropped just 1.1%, while the large cap S&P 500 lost 8.4%. Year to date, the S&P 500 is down 11.39%, while the Russell 2000 has lost just 2.62%. This may be an early indication from the stock market that we are nearer to the end than the start of this unofficial and unannounced recession. Of course, although it is a leading economic indicator, the stock market is not a perfect economic indicator. There is a reasonable

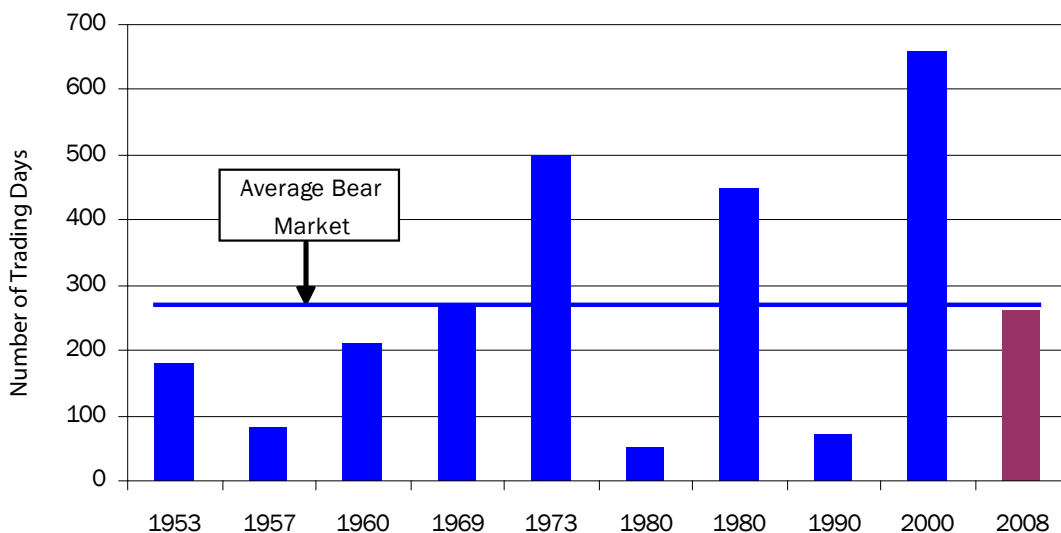
chance that the market is forecasting the end of the recession, and is wrong. For a more dependable assessment of the state of the economy, we could simply wait for the official pronouncement from the NBER. But that could be a long wait. As a recent example, the NBER Business Cycle Dating Committee announced the start of the 2001 recession, which began in March 2001, on November 26, 2001, and did not announce the end of the recession (which also occurred in November 2001) until July 17, 2003. By the time the last recession was officially announced, it was already over, and NBER was almost two years late reporting the end of the recession. Economics truly is a dismal science! These NBER reporting delays illustrate the difficulty inherent in trying to capture precise data to measure and describe short-term phenomena—by the time the data can be collected, whatever is being measured will have changed again.

### Hester on the Recession

In an August 2008 article titled: “The Beginning of the Middle,” William Hester of the Hussman Funds argues that emerging data about economic activity is increasingly confirming many economists’ belief that the U.S. slipped into recession in early 2008. Mr. Hester observes that for every recession since 1980, on average the NBER has publicly reported the recession’s start 7

*This may be an early indication from the stock market that we are nearer to the end than the start of this unofficial and unannounced recession.*

Chart 3: Duration of Recession-Induced Bear Markets (Trading Days)



## ECONOMICS, RECESSIONS AND THE STOCK MARKET

*“If this decline runs the average duration of past recession-induced bears, we could observe the bottom in October.”*

*- William Hester,  
Hussman Funds*

*“Economists set themselves too easy, too useless a task if in tempestuous seasons they can only tell us that when the storm is long past, the ocean is flat again.”*

*- John Maynard Keynes*

months following the actual start of the contraction. He notes that the NBER has marked recessions as early as 5 months from the economy’s peak, and no later than 9 months after the peak. Using data such as unemployment rates and new jobless claims, Mr. Hester suggests that the recession likely began in or around January 2008. Given the average 7 month lag time between the economic peak and the NBER pronouncement, Mr. Hester observes, “That suggests an announcement from the NBER may come sometime over the next couple of months.”

Extending his observations to the relationship between the economy and the average length of bear markets triggered by recessions, Mr. Hester observes that the average recession induced bear market since 1953 has lasted about 300 market days (not counting weekends and holidays), although the 1973, 1980 and 2000 recessionary bear markets lasted significantly longer (the 2000 bear market ran for almost 700 market days). He comments: “If this decline runs the average duration of past recession-induced bears, we could observe the bottom in October. It would be in good company, as a third of all recession-induced bear markets since 1953 have ended in October, but of course, there is far too much variation to place much faith in that outcome.”

### Keynes on Precision and the Long Run

John Maynard Keynes, perhaps the most famous economist of the twentieth century, understood the disconnect between the long run perspective of many economists, and the need for short-term action. He wrote, “But this long run is a misleading guide to current affairs. In the long run we are all dead. Economists set themselves too easy, too useless a task if in tempestuous seasons they can only tell us that when the storm is long past, the ocean is flat again.” Continuing his rant against misplaced efforts to develop unnecessary precision, he also wrote, “I would rather be vaguely right, than precisely wrong.”

### Conclusions

As investors, perhaps the most relevant conclusion we can draw from our review of macroeconomic theory is that most economic statistics have limited direct relevance to our investment decisions. Since the stock market acts as a leading economic indicator, it’s not particularly helpful to investors to know whether or not the economy is in recession — either way, the capital markets have already reacted to the consensus opinion regarding the probability of future recession. To base reasonable investment decisions on economic considerations doesn’t require accurate economic data; rather, it requires materially better than consensus forecasts regarding future economic activity. Waiting for official pronouncements about the state of the economy is obviously useless for investment decisions — an investor withdrawing from the stock market at the end of 2001 following the NBER announcement of a recession had already missed the entire recession, and if they waited to get back in until mid 2003, they also missed much of the post-recession recovery.

But, by better understanding the relationship between economic forecasts, economic activity, economic data, and stock market behavior, investors can be more comfortable responding to inevitable market shocks. At the time of this writing (September 2008), it appears that the US stock market has already priced in a 2008 recession. If NBER announces the start of a 2008 recession sometime in late 2008 or early 2009, investors can accept this pronouncement with equanimity—the NBER merely validates the investor’s actual market experience. The stock market responds to consensus opinions about economic forecasts. As events unfold, actual economic activity occurs and is measured. To the extent that actual activity is better than forecast, the stock market responds favorably, and the reverse is also true. Finally, when all economic activity is measured, tabulated, adjusted, and reported by economists, we are finally able to review economic data. However, the stock market generally ignores these data—it is far more interested in the newest set of economic forecasts.

**SURVEY OF INDICES & FUND AVERAGES**  
PERIOD AND ANNUALIZED COMPOUND RETURNS IN PERCENT

	Third Quarter 2008	12 Months Ending 09/30/08	3 Years Ending 09/30/08	5 Years Ending 09/30/08	10 Years Ending 09/30/08
<b>Inflation Index &amp; Risk Free Rate</b>					
Consumer Price Index	0.68	4.97	3.26	3.41	2.96
U.S. 3-Month Treasury Bills	0.43	2.55	3.98	3.09	3.39
<b>U.S. Stock Market (Large Companies)</b>					
Standard & Poor's (S&P) 500 Index	-8.37	-21.98	0.22	5.17	3.06
S&P/Citigroup Large Cap Growth Index	-11.24	-19.44	0.03	3.27	1.41
S&P/Citigroup Large Cap Value Index	-4.97	-24.50	0.40	7.11	4.05
Avg. Large Cap Blend Fund ‡	-10.21	-22.45	-0.45	4.84	3.61
<b>U.S. Stock Market (Small Companies)</b>					
Russell 2000 Index	-1.11	-14.48	1.83	8.15	7.81
Dimensional US Micro Cap Fund	0.05	-19.33	-0.98	6.87	11.31
Russell 2000 Growth Index	-6.99	-17.07	1.46	6.64	4.67
Russell 2000 Value Index	4.96	-12.25	2.00	9.45	10.14
Avg. Small Cap Blend Fund ‡	-5.55	-18.87	-0.13	7.76	9.01
<b>Real Estate</b>					
DJ Wilshire REIT Index	4.78	-12.46	5.19	13.43	13.04
<b>Fixed Income (Bond) Markets</b>					
Lehman Government Bond Index	1.92	7.90	5.59	4.34	5.34
Avg. Intermediate Gov't Bond Fund ‡	0.43	4.10	3.76	3.17	4.29
Lehman Municipal Bond Index	-3.21	-1.87	1.86	2.84	4.24
Avg. California Intermed/Short Muni Bond ‡	-1.90	-1.15	1.48	1.95	3.34
Credit Suisse High Yield Bond Index	-8.04	-10.03	1.66	4.83	5.32
Avg. High Yield Bond ‡	-8.22	-11.29	0.38	3.59	3.57
Citigroup World Gov't Bond Index	-2.97	5.90	5.58	5.34	5.38
Average World Bond Fund ‡	-5.06	-0.94	2.75	3.92	4.91
<b>International Stocks</b>					
MSCI EAFE Foreign Stock Index	-20.56	-30.50	1.12	9.69	5.02
Average Foreign Large Blend Stock Fund ‡	-20.73	-30.24	1.36	9.24	4.84
MSCI Europe Stock Index	-20.77	-30.93	2.51	10.96	4.78
MSCI Pacific Stock Index	-20.10	-29.61	-1.80	6.91	5.81
MSCI Emerging Mkt Index (excl. dividends)	-27.61	-34.69	5.97	15.82	11.97
Average Emerging Markets Fund ‡	-27.23	-33.36	7.42	17.50	14.01

‡ Source: Morningstar Principia 09/30/2008

## WORLD MARKET SURVEY

(continued from page 1)

### Commodities Collapse, Dollar Strengthens

The Fed pumped money into the US banking system, increasing fears of future inflation. But commodity markets worked in the other direction. Global demand for commodities headed sharply down, damping upward pressure on prices due to unprecedented levels of central bank easing around the world. A slowdown in economic activity sucked oil prices down 28%, to \$101 a barrel. Declines in food futures were even more startling: corn fell 32.7%, and wheat was down a staggering 60.9%. Gold ended the quarter down 5.6%, as the dollar regained 11.8% against the euro and 12% against the pound sterling. The net result: the Consumer Price Index was up only 0.7% for the quarter.

### Foreign Stocks Fare Much Worse

As bad as things were for domestic equity markets, they were just peachy by comparison with foreign exchanges. The Dow Jones World Index was off 22% for the quarter. Every market in the world suffered declines, from a 0.5% loss for Turkey to a punishing 47.8% free fall for Russia. Suffering from the effects of the US financial crisis, developed European stocks split the difference, with the UK down 22%, Germany off 21%, France down 19.2%, and Italy down 23.2%. Emerging Markets were hammered by

the collapse in commodities prices, and a consequent flight to safety in the U.S. The MSCI Emerging Markets Index sank 27.6% for the quarter.

### Small Stocks Hold the Line; REITs Up (!)

The small cap Russell 2000 Index lost only 1.1% for the quarter; perhaps not surprising, given the titanic scale of the corporate collapses of late. After a tough first six months, REITs gained 4.8%.

### Unparalleled Turmoil in Credit Markets

Overnight credit markets briefly locked up on the evening of September 17, prompting emergency action by the Fed. Several money market funds “broke the buck” as a result. While there was no run on money funds, FDIC coverage was extended to money funds on September 19, and the US took over the largest insurer in the world, AIG. The flight from risky bonds and stocks to Treasury securities was so enormous that T-Bill yields briefly fell below 0.0%. Despite torrid demand, total returns for T-Bills for the quarter were 0.41%, a quarter point less than the CPI. At the end of the quarter, the Lehman Government Bond Index was up 1.9%, and the Lehman Aggregate Bond Index was down 0.5%.

### Individual Country Returns Third Quarter 2008

	US Dollar	Local Currency
<b>North America</b>		
United States	-9.1	-9.1
Canada	-23.1	-19.4
<b>Latin America</b>		
Argentina	-19.9	-17.1
Brazil	-38.1	-25.0
Chile	-13.1	-9.1
Mexico	-18.7	-13.3
<b>Africa</b>		
South Africa	-16.8	-12.0
<b>Europe</b>		
Austria	-39.0	-31.6
Belgium	-20.5	-10.8
Denmark	-27.8	-19.0
Finland	-27.5	-18.7
France	-19.2	-9.4
Germany	-21.0	-11.4
Great Britain	-22.0	-12.9
Ireland	-40.2	-32.9
Italy	-23.2	-13.8
Netherlands	-25.8	-16.8
Norway	-41.1	-31.6
Portugal	-19.7	-9.9
Spain	-18.9	-9.1
Sweden	-24.1	-12.1
Switzerland	-13.1	-4.3
<b>Asia</b>		
Australia	-28.1	-12.5
Hong Kong	-26.6	-26.9
Indonesia	-29.6	-28.0
Japan	-18.5	-18.4
New Zealand	-16.6	-4.9
Philippines	-1.0	3.8
Singapore	-25.7	-21.8
South Korea	-25.0	-13.4
Taiwan	-28.8	-24.5
Thailand	-23.7	-22.7

Source: Dow Jones Global Indexes

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