



INVESTMENT  
COUNSEL

## MARKET OUTLOOK

Fourth Quarter 2008

We are living through interesting times, that much is certain. After an unprecedented boom in housing and mortgage-backed investment securities, we are in the midst of an equally unprecedented contraction of those booms. Metaphors and analogies abound and are offered to explain what happened. For those of a culinary bent we might mention the meringue: stiffly beaten egg whites give the appearance of substance but only for a short time. For those who remember Greek mythology we remind them of the story of Icarus, who flew too high against the advice of his father and paid dearly when the wax on his wings was melted by the sun. The losses suffered by many participants in these market segments were not mere metaphors, however. Investors endured drastic write-downs of their portfolios, and bankers, traders, and analysts lost high-paying jobs.

Our clients suffered too, but those losses were mitigated due to efforts we took to maintain a high degree of quality in our client portfolios. Though we were not completely inoculated against what we might call the “sub-prime fever,” we had already taken steps to reduce our exposure to the riskier aspects of the finance industry. Our attention to high quality fixed income securities kept us from making the “yield stretch” that proved so harmful to investors in mortgage-backed securities. We never lost sight of the fact that risk and return go hand in hand. One simply cannot find high yield and high quality at the same time, despite the granting of AAA ratings on sub-prime mortgage derivatives. Our attention to balance sheet strength proved itself through the financial complex meltdown this summer. Most of our non-finance companies have low debt-to-capital ratios and generate solid cash flow to service the debt they carry on their balance sheets. We also reviewed the holdings of the money market funds where our

clients hold cash, and the exposure to illiquid “cash-like” instruments in our clients’ money market funds was very small.

The current situation is marked by sharp market reversals across all sectors of the economy, for the credit contraction being felt most deeply in the financial sector is also felt in other economic sectors. Though clearly weak, the U.S. economy has refused to decline sufficiently to trigger the official calling of a recession by the National Bureau of Economic Research (NBER). Job creation, which had been very low, is now negative. The high price of oil has cut into the budgets of individuals and companies alike. Credit is the fuel for rapid economic growth, so the contraction of credit this year has had a strong negative impact on the growth of GDP. Our global economic system is proving to be dynamic but not disconnected, which means for investors the stock market weakness is also global. An investor cannot ride out the U.S. stock market weakness by moving to a foreign stock market. While the NBER has not made the official recession call, many are experiencing what looks and feels like a recession, and the stock market in its forward-looking fashion has anticipated one.

The U.S. Congress recently passed a bill to provide funding for a plan to stabilize portfolios of mortgage-related investments. While few details have yet come to light, the expected effect of the stabilization plan is renewed confidence and a more liquid market for lending. Every market needs buyers and sellers, and this particular market had frozen to the point that almost no one dared trade the securities. The government action should help the mortgage security market return to its primary function of matching buyers and sellers. More work yet remains on the housing front. Banks will still have to work through

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the stagnant housing market, though without the sense of doom they have had heretofore. Nobody likes the fact that there remain too many homes on the market, but that is the reality and it is especially severe in certain parts of the country. Here again, the U.S. is not alone. Even China is reporting a problem with housing.

The positive aspect of the current market environment is that participants are pricing risk better. Earnings are not declining as much as stock prices, which makes equity valuations appear attractive. There surely are “value traps” – companies which look cheap but are not. Reflecting our interest in financial strength, we have been examining debt-to-capital ratios to help highlight this kind of company. On the other hand, some fine companies have become cheap stocks in the general downdraft of the market, and our job is to make sure our client portfolios hold such companies.

The longer term outlook is for a muted recovery as most economic participants choose to reduce their debt-to-capital ratios. The sub-prime mortgage issue highlights only one component of the recent debt explosion. Many well-to-do individuals bought a second home with a mortgage because interest rates were low, qualification was easy, and home prices were rising. While these buyers are much less likely to default on their debt obligations, their experience with declining home prices and rising interest rates leads many of them to make debt reduction a high priority. In 2008, the price inflation in food and energy has forced people to defer debt reduction in favor of eating and driving. Those trends should reverse somewhat, and consumers will have a few spare dollars in their pocket. Whereas in the past the U.S. consumer has chosen spending over saving, we think in the future he will favor debt reduction over consumption. General economic activity will be somewhat lower, and the economic recovery will be more gradual.

In a slower growth economy, there will still be pockets of growth. The growth rates of the emerging economies may slow, but those rates will remain relatively high. The commodity-export oriented countries like Russia will have to adjust to a lower rate of growth in the price of oil. The labor-arbitrage oriented economies like China and India will have to adjust to a higher domestic standard of living and a reduction in their labor cost advantage. We will position our client portfolios to maximize profits through broad geographic sales exposure. Few of our companies are foreign domiciled, but many derive a significant percentage of their sales and earnings from foreign sources. The relatively high growth in the emerging economies will be a source of growth for many of our investment holdings.

We will continue to look for companies that can support a solid dividend payment to shareholders. In a slower growth future, the dividend becomes more valuable to long-term investors. Truly excellent companies will grow enough to warrant no intermediate cash flows, and we will continue to hunt for those kinds of companies. Balanced with those rare gems, we will have many solid corporate enterprises meeting customer needs and able to pass along some of the earnings in the form of dividend payments. Our fixed income holdings will likewise feature solid sources of cash flows to support the coupon payments and return the principal at maturity. Junk will truly be junk in the future. Care and prudence will be rewarded.

Our clients already know the care with which we manage their accounts. We will remain careful and prudent in our analysis and selection. The financial turbulence we feel now will abate in the future, and we will look back on these times with satisfaction on having successfully navigated through the storm. The course ahead will likely include new storms. We fully expect to make our way through them with the same care as we are making our way through this one.

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