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Overview - In review of 2008, all asset classes experienced significant declines with the exception of the US Treasuries. Each week brought more bad news about another company or industry, wrecking havoc on investor confidence and slowing economic activity globally. The November market lows exasperated by investors' desire to protect assets caused yields on 3-month T-bills to reach as low as 0.01%. While the elevated volatility seen in the last few months continues to imply that 2009 could be just as unnerving, there are reasons to be optimistic. Stock indexes have moved 10-15% above their lows, investment grade corporate bond yields have fallen, market volatility is lower than that seen in November and December, and the market has begun to ignore economic data coming in below expectations, which may indicate that the negative news has been priced in. The next step needed is an improvement in consumer, investor and business confidence which would help speed up the velocity of money (how quickly money turns over) and put an end to the hoarding of cash. With the Federal Funds rate hovering around zero (between 0% and 0.25%), the Fed is enticing investors to consider riskier assets, or receive almost no return at all. Unlike in past recessions where the availability of credit helped elevate consumer and business spending to spur a recovery, this time will be more challenging for corporations to grow revenues with the limited ability to borrow. To ease this situation, the government has taken great strides to facilitate lending and due to its action, credit has begun to moderately improve.

Recognizing the extreme market conditions, LTAM took many steps in 2008, as described below, in an effort to protect assets and capitalize on opportunities. We continue to identify the best of breed funds for your portfolio and made fund exchanges which allowed us to realize losses that you can apply towards future capital gains.

Domestic - The S&P 500 Total Return Index returned -37% in 2008 closing out what is being called the "lost decade". Historically, when markets record flat returns in one decade, they tend to produce above average returns for the next. Since all equities asset classes were negatively affected, LTAM tilted the portfolio to growth stocks primarily in the large cap sector which have traditionally rebounded better than value or lower cap stocks. With valuations near historical lows we believe this is an opportunity to cautiously begin purchasing US equities.

Developed & Emerging Foreign Markets - Even more affected, International Developed (MSCI EAFE Index) returned -43.38% and Emerging markets (MSCI EM Index) returned -53.33% for the year (-36.4% and -47.1% respectively in the second half) . While many investors had hoped international markets would help to hedge their portfolios from domestic problems, this was not the case since all equities were highly correlated and fell together. Although we maintained an allocation to developed and emerging markets throughout 2008, overall we reduced our exposure expecting more volatility relative to the US. Going forward, we will look for correlations to return to historical norms prior to increasing our allocation to these asset classes.

Fixed Income - A desire to flee risky assets caused Treasuries to be the best performing asset class resulting in increased prices and yields near their lows of the 1940s. Rates at such historically low levels reflect not only a poor economic situation in the US, but an extreme fear in the marketplace both domestically and internationally. In December 2008, LTAM added a high yield debt allocation to the LAMP portfolios fulfilled by the Wells Fargo Advantage High Income fund (SHYYX). The credit spread (which is the extra yield investors demand to compensate for risk) between High Yield Corporate Debt and Treasuries was and continues to be at an unprecedented level. The average yield on below-investment-grade debt was over 20% for the first time in history which indicates the market expects increased defaults. However, default rates for the high yield index are currently below the historical average of 5%. Although expectations are that default rates will significantly increase in the next six to twelve months, much of this is already priced into the market. With bonds trading at such massive discounts, the upside potential will be in line with the returns of equities. Unlike with equities though, we will essentially be “paid to wait” for a recovery in the market by the income generated from this fund.

Real Estate - U.S. REITs declined 38% in the fourth quarter of 2008, versus a 22% drop in the S&P 500. At the end of December, the yield on U.S. REIT indexes was 8.8% and the spread to the 10-year Treasury was 6.5% placing them at their most attractive levels in decades. The Federal Reserve's direct purchases of mortgage backed securities has already been successful in its goal of lowering mortgage rates by 20% below their peak and helping to stimulate the real estate market. Existing home sales have accelerated in some of the hardest hit markets including; California, Nevada, and Arizona. Historically, this asset class has been extremely profitable and we continue to hold a small allocation in domestic REITs due to their attractive yields and traditionally low correlation to stock and bond markets.

Alternative Investments - The global economic slowdown has caused a significant reduction in the demand for Natural Resources resulting in prices falling dramatically. Oil has retreated from an all-time high of $147 per barrel in July to under $40 per barrel in December 2008. Numerous times in 2008 we secured profits in commodities and reduced our exposure but we maintain our allocation to capitalize on future demands. We also added the Rydex Managed Futures fund (RYMFX) which has allowed us to capture performance based on the trends of the commodity futures markets.

Conclusion - History has proven that a diversified portfolio has performed well given a long-term time horizon. The LTAM asset allocations are strategically positioned to perform according to your risk profile and our tactical asset class shifts and fund selections are intended to add performance within these risk tolerances. We are cautiously optimistic on the near-term market outlook but fundamentally believe in our long-term investment approach.