

2009 – Hangover or Hope?

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“From an investment perspective, the one positive thing about 2008 was that it lasted only 12 months.”

How Did We Get to a Disastrous 2008?

We’ve all been bombarded by the media about the root causes for the precipitous declines in world markets. For the first time, we’re presenting our investment strategy in bullet-point form. We didn’t want it to look like a newspaper or magazine article – they have been too depressing. We’ve been discussing the potential landmines for our economy and markets for the past year or so. Please see our past investment strategy pieces at www.masseyquick.com. Go to the home page, move your cursor to the research button, and click on “Massey Quick Investment Strategy”. To recap:

- During the Greenspan era, the Fed kept rates too low for too long.
- “Easy” money provided the opportunity to leverage financial assets, residential real estate, and commercial real estate.
- Lending became credit insensitive. Leverage inflated asset prices. The bubble began to build.
- Many financial institutions leveraged their balance sheets to amplify returns.
- Questionable and creative mortgage practices inflated home prices to unsustainable levels. Regional speculation became rampant (Florida, Nevada, California, etc.).
- The bubble began to pop. A crisis of confidence began to unfold.
- The balance sheets of many financial institutions deteriorated and became illiquid.
- Interbank lending ground to a halt. Counterparty risk became paramount.
- The abject failure of a number of banks and investment banks brought government intervention.
- The bankruptcy of Lehman Brothers created a major shock to the system.
- An immense amount of capital was destroyed.
- The lending market ground to a halt. Capital became expensive or unavailable.

- The flight to liquidity rocked the equity markets and fundamentals detached from stock prices.
- Spreads on corporate and municipal debt widened to record levels.
- Fear ruled the day.

2008 Markets at a Glance

S&P 500	-37.41%
Dow Jones Industrials	-33.84%
NASDAQ	-40.54%
Russell 2000	-34.80%
EAFE	-42.12%
London FTSE	-31.33%
German DAX	-40.37%
Japan Topix	-48.88%
MSCI Emerging Market	-49.45%
Brazil Bovespa	-41.22%
Shanghai Composite	-65.39%
BSE Sensex (India)	-52.44%
Lehman Aggregate Index (Fixed Income)	+6.12%
HFRI Fund of Funds Index	-20.96%
HFRI Equity Hedge Index	-26.24%
Massey Quick Composite Performance*	-17.91%

*Represents composite performance for all accounts advised by Massey, Quick & Co., LLC. Please see the disclaimer at the end of this piece.

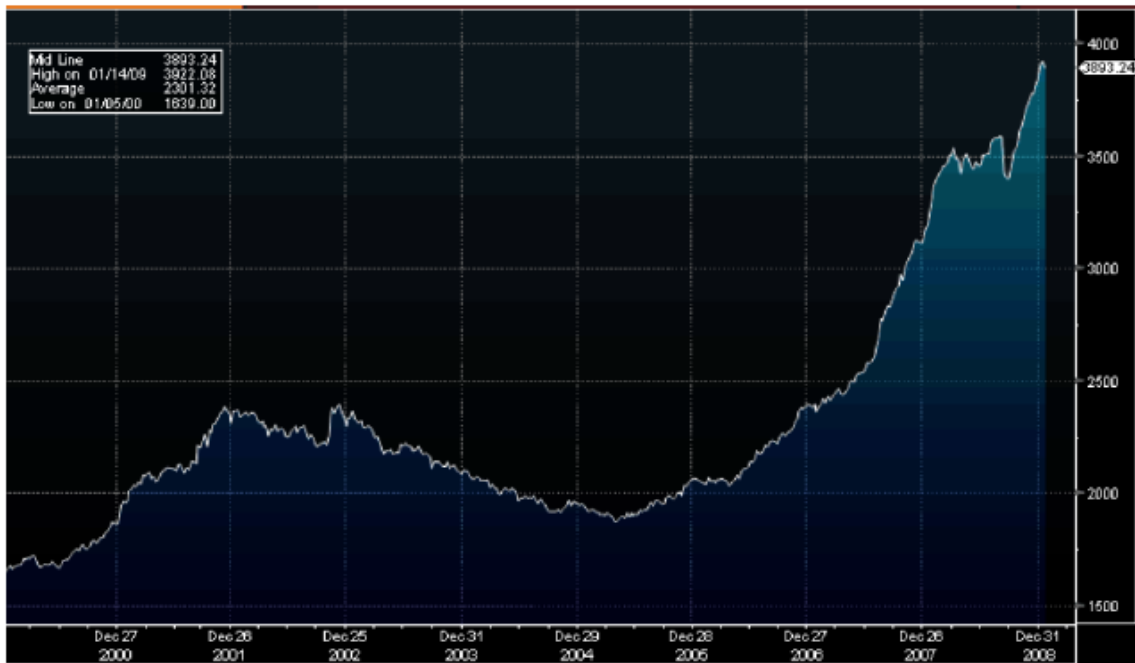


2009: Negative Surprises May Arise

We certainly didn't get off to a good start in 2009. The S&P 500 was down 8.40% in January. World markets didn't perform much better. Clearly, we're still in hangover mode. There will be more bad news. Markets, while they react to short-term news, are discounting mechanisms. By nature, they are forward-looking. As long as bad surprises continue to come, expect to see continued pressure on the capital markets. We believe that the vast majority of the bad surprises will take place in the first half of the year. We view them as follows:

- The housing bubble has popped and residential real estate will likely remain under extreme pressure. Some regions of the country will be more affected than others.
- Consumer spending has dropped off a cliff. Even those that can afford to spend are keeping their wallets closed. Everything is discretionary. Credit card delinquencies are rising. Consumer confidence is at an all-time low.
- Unemployment is moving higher at a fast pace. It seems that major layoffs, not just in the financial services sector, are taking place every day.
- Small businesses are dying on the vine.
- The economy is clearly in the midst of a recession. Real GDP growth will be negative this year. There is a great deal of uncertainty surrounding the duration of this recession. Some believe we are headed toward a Japanese style deflationary spiral.
- Many large financial institutions are packed with bad loans and unmarketable and complex illiquid positions on their balance sheets. Look for continuing problems and consolidation.
- Retailers, and their suppliers, are under tremendous pressure. Bankruptcies in this sector will continue through the first half of the year.
- Commercial real estate is beginning to deteriorate rapidly. There is more bad news ahead.
- The credit markets are beginning to thaw, but financing is still hard to come by. Banks are not lending and the bond markets are essentially closed to many issuers. Whether you are a viable corporation or first-time homebuyer, credit is largely unavailable.
- Funding for stressed and distressed companies will be hard to find. Return on capital for these companies will diminish as the price of capital rises.
- Some states and municipalities will come under financial pressure as their tax base erodes.
- Economies outside the United States will continue to deteriorate.
- Generally, corporate earnings continue to disappoint. Earnings expectations are drifting lower.

- The massive deleveraging that took place in the latter half of 2008 decimated stock prices and forced fixed income spreads to record levels. Fundamentals have decoupled from stock and bond pricing. Capital markets have been driven largely by macro events.
- Investors have abandoned their long-term investment horizons. People are thinking in terms of months, not years. Massive liquidation of mutual funds and 401K plans, and the subsequent flight to cash, has also placed enormous pressure on stock prices. The following chart depicts the growth in money market fund assets from January of 2000 through January of 2009.



Source: Bloomberg

The key question is: How much of this bad news is already recognized by investors and already discounted into the markets?

There Are Positive Factors at Work

There are positive factors at work. It's difficult to focus on them, especially when the media carries the bad news to our door every morning. I was on my way back to the office from the airport last week and turned on the radio to get an update on markets. The announcer started out by saying that the markets were weak again that morning and went on to say that the S&P, the Dow Jones, and NASDAQ were all up marginally. Even good news is presented with a negative bias. We've all become accustomed to the "CNBC culture" of urgency and velocity. My advice: turn off the TV and focus on the longer term. The positive developments at work include:



- While one can argue with the merits of our recent fiscal and monetary policy directives, at least the Treasury and the Fed were decisive when our financial system was on the verge of a meltdown. Other developed nations floundered in their decision-making. As a result, the United States is better positioned to exit the global recession from a position of relative strength.
- The proposed economic stimulus package, while not perfect, should begin the process of recreating economic growth. Congress will come under scrutiny and wasteful spending will not be tolerated.
- Monetary policy, bringing the Fed Funds rate essentially to zero, should begin to thaw the credit markets and make capital available again.
- Expect to see fiscal policy initiatives that include implicit guarantees for Fannie Mae and Freddie Mac debt to help stimulate mortgage lending, incentives for first-time homebuyers, tax cuts for low and middle income families, and stability of current income and capital gains taxes for the more well-to-do.
- The dramatic fall in the price of oil will relieve the consumer from sky-high gasoline prices and heating bills.
- There will be massive re-regulation of the financial markets. Everything is on the table from the registration of hedge funds to executive compensation. While we don't expect the nationalization of banks, these institutions need to realize the government will have a strong hand in guiding the rehabilitation of our financial system.
- The actions of the Federal Reserve and the Treasury will have more of a positive impact than economic stimulus. Expect to see the creation of a "bad bank" to remove toxic assets from the balance sheets of financial institutions combined with the end of mark-to-market accounting. This will be followed by a tremendous amount of arm-twisting to force banks to lend again.
- Cash abounds. Low returns on "safe harbor" investments will eventually force investors up the risk curve. They will begin buying stocks and bonds again. Currently, cash in money market funds is greater than 40% of the market capitalization of the entire S&P 500. This doesn't include CDs, T-bills, or other short-term liquid assets. There is an immense amount of buying power on the sidelines.

How Will Equity Markets Behave?

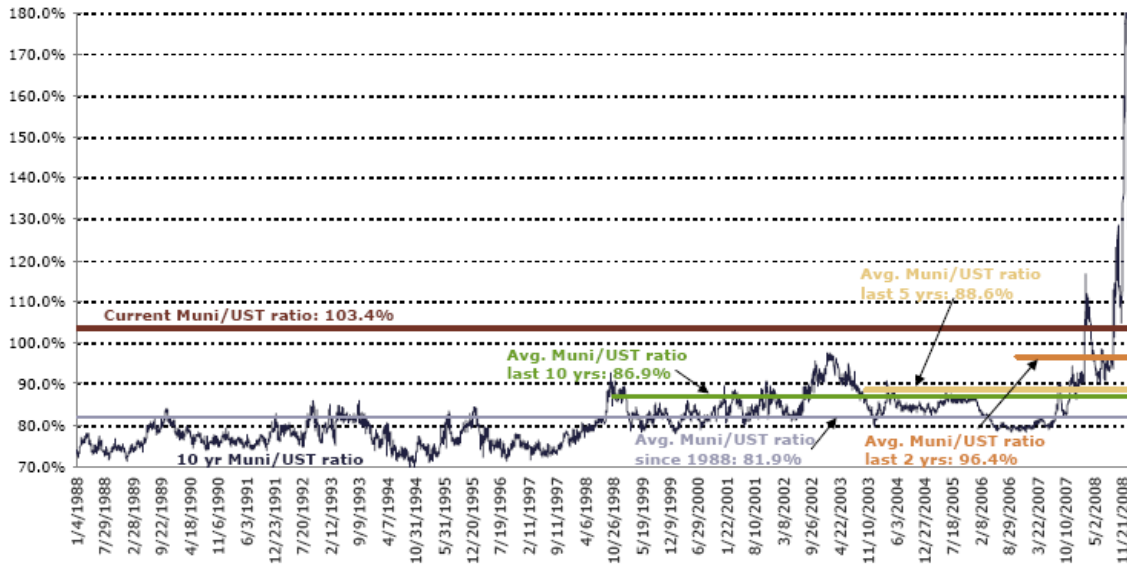
- Stocks and bonds are discounting mechanisms. They anticipate news. In order for markets to turn, we don't need to see a flurry of good news. The bad surprises have to stop. At this point, investor confidence will rebuild.
- Volatility will continue through the first quarter of 2009. Look for days of joy followed by days of despair as investors weigh the positives and negatives.

- Listed companies will be placed into three categories: The Good, The Bad, and The Ugly.
- “The Good” will be companies with strong balance sheets, supportive dividends, strong business franchises, and sustainable and growing free cash flow. They will be well-positioned to feed on “The Bad” and “The Ugly”. They will gain market share and pricing power. “The Good” will be the first movers when markets turn.
- “The Bad” will have weaker balance sheets and financing needs that will serve as an overhang on their stock prices. A thaw in the credit markets will help these companies the most.
- “The Ugly” may not make it. They will have too much debt, a weak position in their industry, and the fear of counterparty risk hanging over their heads.
- Markets may retest their lows on further bad news. We would begin to allocate to stocks in the 750 range of the S&P 500.
- At some point this year, fundamental analysis will reattach to stock prices. We will seek out long-only managers that focus on companies in “The Good” category.
- Our long/short equity managers will be well-positioned to take advantage of their strong fundamentally driven stock-picking processes. They will divide “The Good” from “The Bad” and “The Ugly” and position their longs and shorts accordingly. We will remain overweight in this asset class.
- Emerging market equities have been pounded. Now is not the time, but we are looking for a re-entry point.

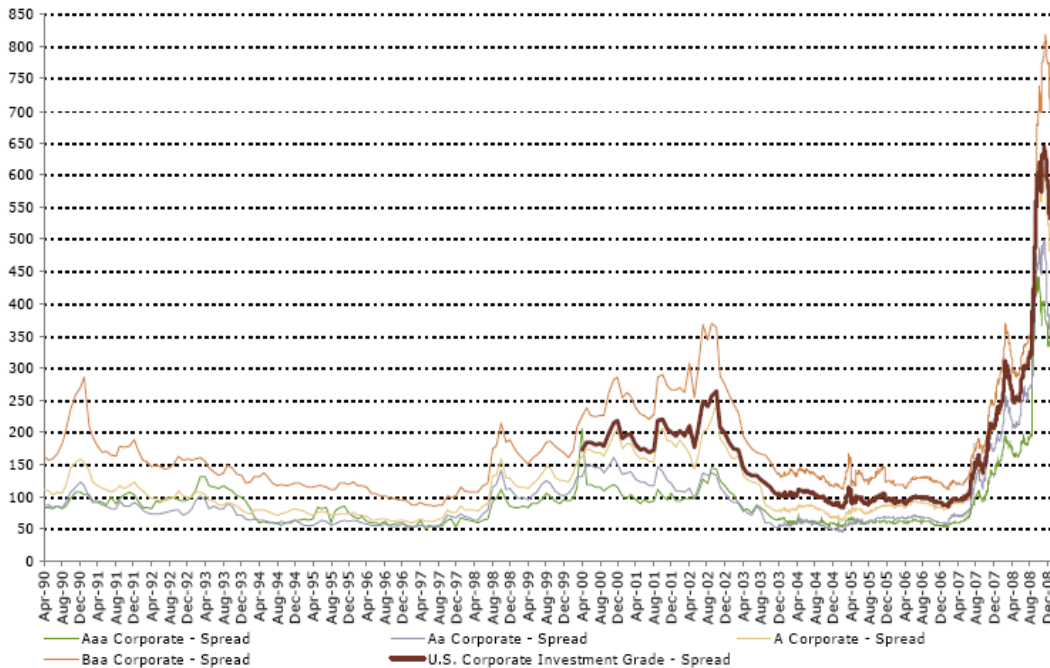
Fixed Income is Attractive Again

- The Fed will keep interest rates low for the rest of the year as they work to repair the financial system.
- Treasury bonds are purposefully overpriced. They are one of the least attractive asset classes in the world today. The Fed is hoping this will move capital up the risk curve.
- Investment grade municipal bonds represent an outstanding value. In December of 2008, AAA municipal general obligation bonds with 10-year maturities had an average yield of 173% of treasury bonds of similar maturities. The historical average is 85% of treasuries. By January 20th, the spread narrowed to 103% of treasuries, still historically high. From this point, we would scale into a high quality portfolio with an average maturity of five to seven years. Municipal portfolios should not be self-managed. Credit research is paramount. Active management will produce better results than passive strategies like bond ladders. If spreads were to widen again, we would become very aggressive in stepping up our purchases. The following chart shows the historical spread for 10-year AAA general obligation bonds versus 10-year treasury notes.

10 yr AAA G.O. Municipals / 10 yr UST Ratios



- Investment grade corporate bonds also represent value. Similar to municipals, yield spreads have narrowed over the last month. If they were to widen again, we would focus on investment-grade non-financial issuers with maturities in the 5-7 year range. Once again, credit research is paramount. The following chart depicts historical yield spreads for corporate bonds since 1990. The aberrational yield spreads represent a highly unusual opportunity.



- High yield bonds and emerging market debt should be avoided. Troubled companies are carrying too much leverage on their balance sheets and the risk of a reorganization of the capital structure of stressed companies combined with their general inability to refinance places us too early in the cycle. Many emerging economies will be plagued by weak global consumer demand and the significant decline in natural resource prices.
- There will be an opportunity to add TIPs (Treasury Inflation Protected Securities) to portfolios later in the year. If we go through another wave of recession/deflation fear, look for a buying opportunity.

Inflation Protection

All of the liquidity being pumped into economies worldwide has long-term implications. At some point, inflation will be back. “The Good” will gain pricing power, people will start consuming again and manufacturing will pick up. We expect to see another deflation scare before the year is out. This will push TIPs, oil, gold, and other commodities to attractive levels. At that point, we’ll be adding inflation protection back into our portfolios. We would be direct purchasers of TIPs and use ETFs for other hard assets.

Thinking Long-Term

About ten years ago, I was on a flight from Tokyo to New York. The flight was uneventful until suddenly, we hit severe turbulence. It came upon us very quickly. The food cart hit the ceiling and things were flying everywhere. The severe ride lasted for about 20 minutes (it seemed like 20 hours) and it ended as suddenly as it started. I was shaken – literally and figuratively. Everyone on the plane was shaken. A week later, it was time for me to fly back to Japan. The memory of that turbulence stuck with me, but I knew I had to get on that plane in order to get home, get back to work, and be with my family again. My seatbelt was fastened a little tighter than usual and I didn’t get up from my seat as often as I usually did. The flight was smooth and uneventful, but it took me a good year to rid myself of that little bit of fear that hit me every time I stepped on a plane. What we all experienced in the past year isn’t unlike that flight. We are shaken. We feel a sense of fear and betrayal. There was no place to hide.

It’s difficult to think in terms of years right now. Recently, I’ve talked to many investors with traditionally long-term investment horizons who are thinking in terms of weeks and months, not years. This is human nature. Time and opportunity govern asset allocation. This difficult time will pass. Fear and greed are both powerful emotions. Nobody can time the bottom or the top of a market. Our role is to understand your time horizon and guide you to the opportunities we see today. Whether you are an individual investor or a member of an investment committee shepherding the endowment of an

institution, look forward. Reevaluate your asset allocation. Reevaluate your managers. Get the right team in place for the opportunities that are presenting themselves today. Try to think in years. It is very hard to do, but fortunes will be made coming out of this mess we are in now.

Buy

Long/Short Equity
Long/Short Fixed Income
“The Good”
Equities (S&P 750 range)
Investment-Grade Munis
High-Grade Corporates
High Dividend, Non-Financial
Equities

On the Radar Screen

TIPS
Oil ETFs
Commodity ETFs
Emerging Market Equities

Sell

European Equities
Junk Bonds
“The Bad”
“The Ugly”
Emerging Market Debt
Japanese Equities

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