February 2008

Following on the heels of turmoil in the credit and housing markets last summer and fall, the months of November 2007 through February 2008 have been challenging, to say the least. Looking at the measures major media uses to assess the state of markets, things look rather dismal. As Figure 1 shows, the trailing four-month returns on the Dow Jones 30 Industrials, the S&P 500 and the NASDAQ are all decidedly negative.

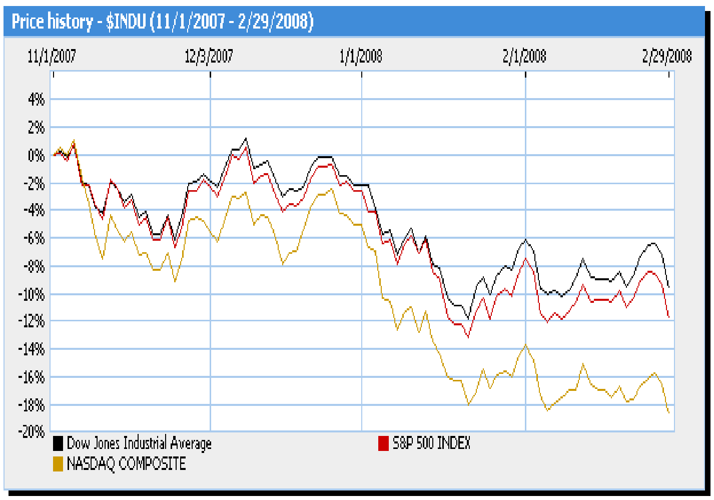


Figure 1

Regardless how "indicative" we feel these indices are of the performance of our portfolios, any time markets go through a period like this, investor sentiment becomes very negative and most of us, no matter how seasoned an investor we may be, begin to ask questions. "Is this sort of decline unprecedented?"

Well, historical perspective is a wonderful thing. It brings clarity at times when emotion might otherwise rule. We don't have to look back very far to see other examples of markets behaving badly.

Figure 2 shows the same indices mentioned above, over the first nine months of 2002. The effects of September 11 and the scandals surrounding WorldCom and Enron were dominating. This ugly period followed a similar period only a year earlier.

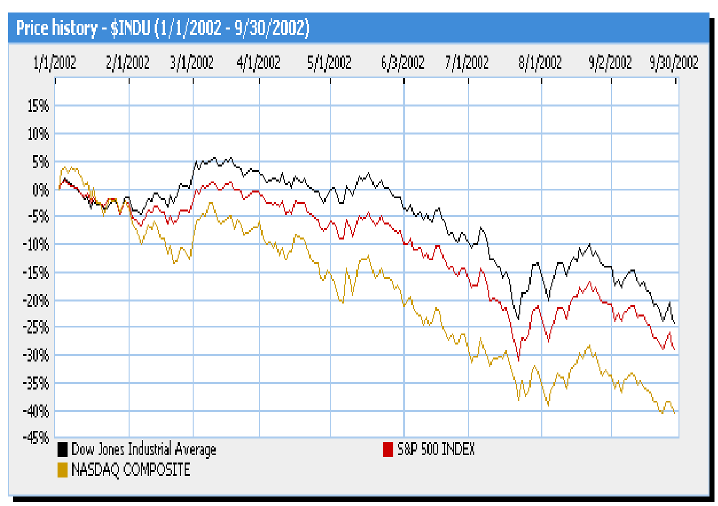


Figure 2

FOSTER GROUP

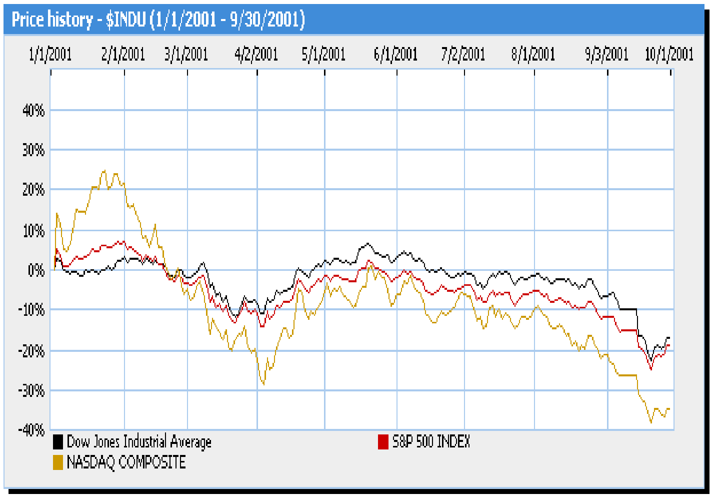


Figure 3

In the first nine months of 2001, Figure 3 shows the implosion of the dot.com bubble. Technology and telecom companies that had done so extremely well in the late '90's suddenly were taking a merciless beating, and the indices again fell rapidly.

Three years earlier, markets were rocked by what came to be known as "The Asian Contagion", an abrupt downdraft that began in 1997 with the collapse of the currency in Thailand and ultimately spread around the world to dramatically affect equities markets in the late summer of 1998. Figure 4 shows its effect over a period of only about 45 days.

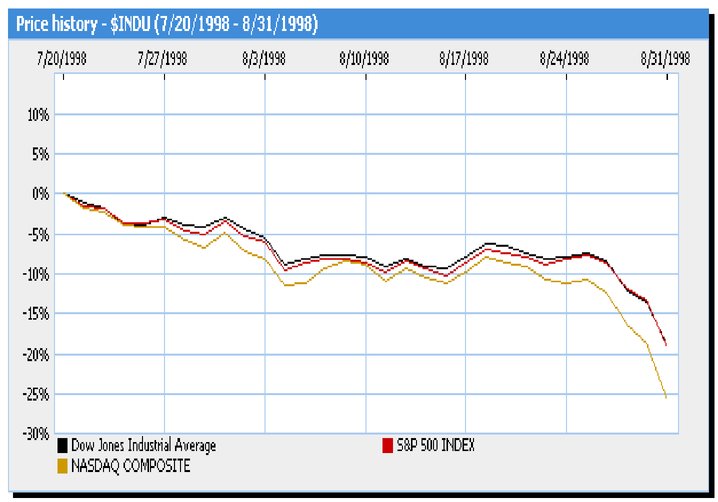
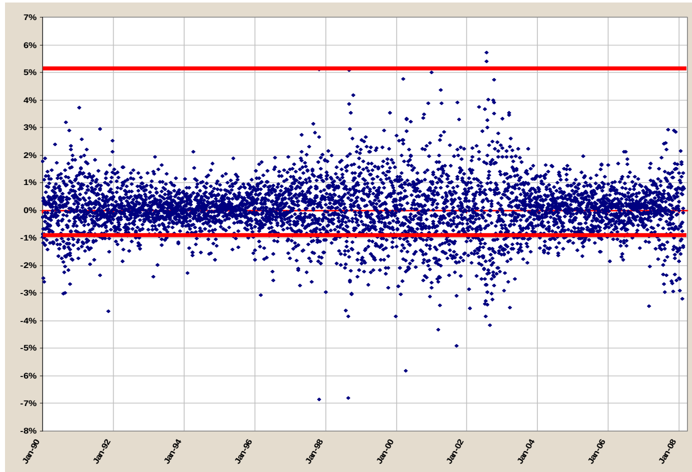


Figure 4

So, as uncomfortable as the present may be, from a historical perspective, it's far from unprecedented.

Another favorite media topic these days is the amount of volatility we're experiencing. The indices we've been discussing ***have*** had some significant ups and downs over the past few months. More downs than ups, actually! Those down days are no fun, and again, they cause us to ask questions. "Is the market behaving in an unusual manner?"

Figure 5



In Figure 5, each blue dot represents a single daily movement of the S&P 500 index, expressed on a percentage basis, from 1990 through mid-February 2008. The red lines represent a 6% range (3% up and down from a zero mid-point).

As you can see, over the past seventeen years, there are numerous points where volatility has been ***greater*** than what we've experienced recently and even more points that are similar in magnitude. Had the time frame for this chart begun three years earlier, the downward scale would have to ***more than double*** to accommodate the single-day drop of "Black Monday" in October 1987.

What's unusual about the current volatility is not that it's exceptionally high. Instead, it's the rather extended period of time over the past three to four years when volatility was actually ***less*** than might normally be expected. That may have caused some investors to forget how equity markets really behave!

To that point, equity markets ***must*** have this kind of volatility periodically in order to reward long-term investors with higher rates of return. As Figure 6 shows, the price paid for the much smoother ride of portfolios made up of bonds or T-Bills is the significantly lower ending value. That's simply capital markets at work, assessing risk and compensating investors for the amount of risk they're willing to assume.

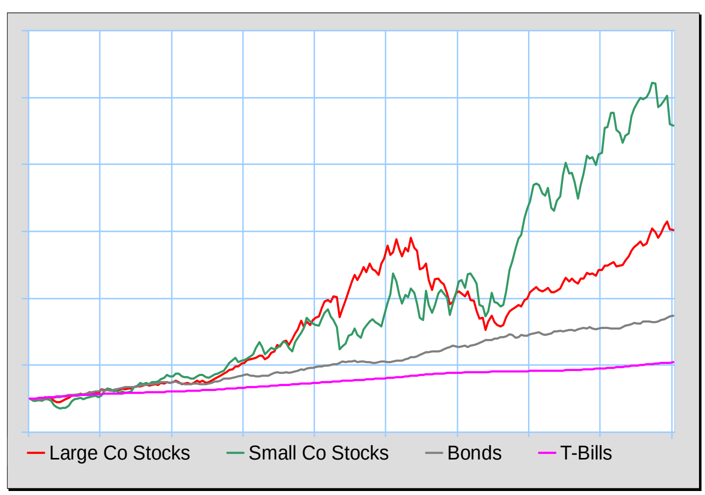


Figure 6

Another topic garnering a tremendous amount of press coverage these days is the prospect of our economy slipping into recession. Much of the popular media has discussed this *ad nauseum* for the past year or more. Many seem determined to find evidence of this long-awaited recession, but the facts don't seem to be cooperating with them.

Recall that the greatest risk to recession exists when the recession begins ***unexpectedly***. This catches business and industry off-guard with payroll that's too high, inventory levels that are too high, capital spending projects committed that depend on future sales for funding, and perhaps cash levels that are insufficient to weather the storm of a recessionary period. If a recession were to occur this year, it would be one of the most forecast recessions in recorded history. Any company or individual caught unaware would certainly have no excuse!

Today, however, we find little evidence that these conditions exist. With the exceptions of housing and anything related to sub-prime lending, which are clearly having their share of problems, corporate profit levels are generally high. Cash levels are high as well; corporate CFO's and treasurers have been less willing to reinvest profit in operations at the levels seen a few years ago. Corporate inventories are fairly low, indicating production and employment must continue in order to meet present and future demand.

While consumer ***confidence*** seems relatively weak (not surprisingly), that does not seem to have translated directly to consumer ***spending***. Consumers have continued to spend at levels far above being considered weak. Contributing to this are tax rates that are at historically favorable levels. While we might all wish they were lower still, we do not have personal or corporate marginal tax rates exceeding 50%, as was once the case.

Another major contributing factor is monetary policy – what the Federal Reserve does.

Figure 7 shows the pattern of the Fed's target rate over the past seventeen years. After a series of seventeen consecutive increases beginning in June of 2004 (red arrow), the Fed reversed course in August last year and has made six consecutive cuts since then. The current target rate is 3%, putting us back where we were in mid-2005 on the way up (blue line).

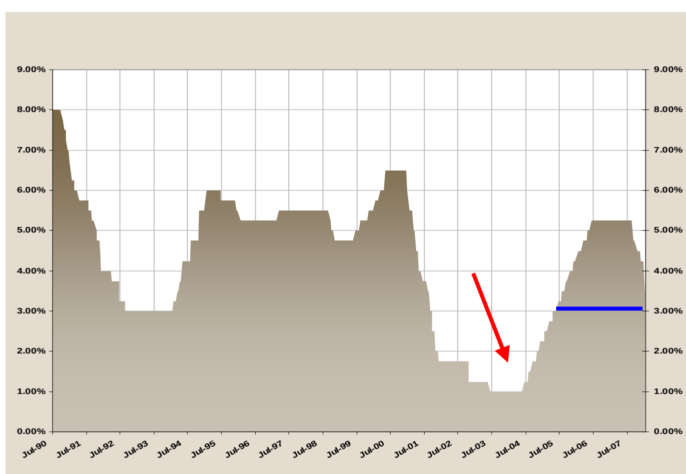


Figure 7

The clear message being sent from the Fed in recent days is that they will go to almost ***any*** length to prevent the economy from slipping into recession. It typically takes about nine months for the effects of a Fed move to begin being felt in the economy. We're getting close to that time frame on the first decrease made last August. There is a tremendous amount of stimulus "in the pipeline" that has yet to be felt, economically speaking.

So, with all that information as backdrop, we're left with the question of how we should respond to the current situation. What action, if any, should we take and how should we think about what's happening around us? We have three recommendations for your consideration:

Remember the job of the media. It's ***not*** to give you sound investment advice. In the final analysis, the media's job is to sell newspapers and magazines, newsletter subscriptions and advertising airtime. You don't accomplish those things by telling a consistent, positive story. You accomplish those things by telling a sensational story, with a bit of fear mixed in, so that each day readers and viewers will return to see what new information is available. If you grid what you hear in the media through that filter, it will make a great deal more sense.

Stick with your Investment Policy. It was designed to manage the emotions of fear and greed. Today, we're experiencing the "fear" part of that equation. Periods of time like this, and the investment mistakes they can cause, are ***exactly*** what it was designed to protect you from. Your plan was purposely developed with periods of time like this in mind. Although they're no fun, they are not unexpected or unusual.

Call with questions or concerns. Sometimes, a bit of encouragement is not only welcome, it's necessary. If you'd like to discuss your situation in more detail, we invite you to call, e-mail or stop in to see us. We'd welcome the chance to visit with you further.