February 2009

Dear Client,

Enclosed are the 2008 returns for your account(s). Where applicable, three, five and ten year returns are included as well.

The S&P 500 index returned -37.00% in 2008 including dividends. Our composite account returned -25.96% for the year (individual results may vary). Results for our composite, since inception on 01/01/2000 and through 12/31/2008, were +41.08% vs. -28.18% for the S&P 500 with dividends. Annually, that works out to +3.96% for the composite and -3.61% for the S&P 500. Stocks have now recorded their worst ten-year cumulative return ever and many investors are questioning the role, and indeed the reason for *any* allocation towards this now reviled asset class. The balance of this letter will be devoted to offering some perspective on historical stock price behavior/returns and attempt to peer into the future and provide some optimism on why the next decade will almost certainly produce very satisfactory returns for owners of a reasonably diversified portfolio of stocks.

Ownership of a business, whether privately or through the mechanism of publicly traded stocks, presents the opportunity to share in the success or failure that the business encounters as it navigates the marketplace. Over time, one hopes that increased sales will beget increased profits, dividends and ultimately, a higher stock price. Put more simply, it represents a claim on all the future earnings of the company. This claim on future earnings is what is responsible for the superior performance of stocks over long periods. Of course depending on the era or start date, the period of time required in order to enjoy returns commensurate with the risk can genuinely test one's patience.

When I began my career as an employee of a small brokerage firm in 1982, the Dow Jones Industrial Average (DJIA) was trading in the low 900's. This was essentially the same level it had reached in July 1965 and included a sickening slide to 584 following President Nixon's resignation in 1974. Essentially, stocks went nowhere for seventeen years with a forty percent drop in-between. In October 1982 the market took off, and not withstanding the 1987 crash and 1990-1991 recession, reached nearly 12,000 by the end of 1999. That's approximately a 1,300% increase or a compounded annual return in excess of sixteen percent. This pattern of long periods of sub-par returns followed by long periods of excellent returns is by no means unusual. It has occurred frequently and merely demonstrates that stocks are mean-reverting.

In a recent paper for Vanguard's Institutional Investor Group, Francis Kinniry Jr. and Christopher Philips write "The returns from any particular period are an unreliable anchor for long-term return expectations." This applies to even longer horizons of ten or twenty years. By way of example, when calculating ten-year returns, shifting the start date by four years changes eighty percent of the data. For longer periods, say twenty-year returns, a shift of six years changes sixty percent of the data. Why is this important? Because by lopping off a series a poor performing years, or adding a series of good performing years, the picture painted by a particular asset class- in this case stocks- can be misleading. Without trying to get too technical, the paper goes on to point out that although stocks have a mean annual return of ten-percent for all ten year periods since 1926, "investors can reasonably expect to see a ten-year return average between 0% and 20% about 95% of the time." Quite a range and interestingly, fairly close to the wide range of returns investors experienced in the personal example cited above.

Our last correspondence to clients was in November 2008 (to access the letter go to: http://www.highlandercapital.com/commentary.php). Since then, the credit markets have thawed and prices of many corporate and municipal bonds have rallied. While we were able to pick up many bargains in the fixed income arena at exceptional prices and yields, the equity markets have continued their losses into the new year with the S&P 500 -14% through late February. As I indicated then, many businesses were priced for insolvency or at the very least, sharply diminished future earnings. While it is obvious that short-term earnings will be impacted, it by no means obvious that the long-term picture has been fundamentally altered. Aggregate corporate profits over long periods of time have always grown; albeit not in a linear fashion. It is true that some poorly capitalized or uncompetitive businesses will fail and have to be shuttered or reorganized. Equally true is the fact that inventories will ultimately clear, loans will stop souring, bank balance sheets will mend, demand will pick-up, and growth will resume.

For forward looking investors, there is a very high probability that the aggregate earnings of the S&P 500 will be meaningfully higher in ten years. This, coupled with the very large decline in prices of common stocks and the high dividend yields relative to bonds suggests to us attractive prospects for equities.

In closing, we know that these are stressful times. The constant barrage of negative news headlines and shrill bleating masquerading as investment advice emanating from some of the financial news networks can exert a powerful emotional force on the decision making process. To the extent possible, this should be resisted. The market is there to serve you and not to guide you. Falling under its manic-depressive spell is not conducive to long-term investment success. A rational approach, taking advantage of the opportunities presented by lower prices on a case by case basis seems to us the better course of action.

Please feel free to contact us with any questions or comments. As always, we thank you for your trust and patience.

Very truly yours

Eckart A. Weeck
Managing Director