

First Quarter
2009



Investment Commentary

Stocks saw their best one-month gain in March in more than six years, and while it was a welcome respite from the battering of January and February, the first quarter still ended with a double digit decline for equities. The large-cap Standard & Poor's 500 Index surged 8.8% in March, yet finished the quarter with a total return of minus 11%. Small-cap stocks, as measured by the Russell 2000, were up 8.9% in March, though down 15% for the quarter. Mid-cap stocks in the S&P 400 were higher by 9% in March, but off 8.7% for the entire quarter. Real estate investment trusts, battered by deteriorating fundamentals and fears about debt rollovers, were down 32.1% for the quarter after a modest rebound in March. International stocks, as measured by the MSCI EAFE Index, were higher by 5.9% in March, though off by 14.6% for the first quarter. Although most bonds prices were lower in March, some fixed income securities were able to generate slightly positive returns for the quarter.



The list of issues affecting today's investment landscape is extensive; at the top is the dismal state of the global economy. The fundamental problem is that over the past several economic cycles, U.S. households and financial services businesses took on increasing amounts of debt in order to fund consumption and investments. This trend was self-reinforcing as purchases with borrowed money drove up asset prices (such as homes and financial stocks) and profits, which supported even more borrowing. Ultimately this upward spiral was unsustainable, and its unwinding has created an adverse feedback loop of falling asset prices and lower spending and profits. As the economy deteriorates,

contributing factors (such as rising unemployment, mortgage defaults, loan write-offs, reduced lending, and overall fear) all fuel one another.

In such a situation, many experts felt that the government needed to step in as a consumer and lender of last resort to try to stop or mitigate the effects of this adverse feedback loop. In effect, the public sector (the government) was forced to take on more leverage and spend more in order to try to plug the gap created by the deleveraging in the private sector. The \$800 billion fiscal stimulus package and the monetary and credit policy actions undertaken by the Federal Reserve and the Treasury to support the financial and credit markets are the result so far. Additionally, the federal government is going to play a defining role in the fate of General Motors and the ultimate impact of their decisions on the economy may be unknown for sometime to come.

We agree that stopping a debt-deflation spiral from taking hold is very important, but there remains a lot of uncertainty as to how the government's efforts will play out. Generally speaking, we think that the policies and programs recently announced are likely to help move the economy towards recovery, but they may not alone solve the problems we are facing and we may well see more government action in the months ahead. In our opinion, no matter what policies are introduced, the impact of consumer and financial system deleveraging will almost certainly be a drag on economic growth over the next several years, as saving and paying down debt replaces borrowing and spending. We also believe that there will likely be a price to pay down the road for the current policy actions in the form of a weaker U.S. dollar, higher inflation, as well as higher interest rates and tax rates.

In order to make sound investment decisions in such an uncertain world, it is important to

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consider the current situation in a historical context. While there can certainly be debate about the similarities and differences of past economic meltdowns with the current environment, the performance of the market is not unprecedented and in each prior cycle, investors were faced with similar despair. Severe market downturns in previous market cycles generally proved to be attractive opportunities for committing funds for long term investors. Corporate earnings and P/E multiples are likely to revert to their long-term trend averages as the global economy improves. But in spite of the strong rally we are experiencing as we write this, the path from here to there is likely to be bumpy and there could still be some big dips along the way. It is important that investors try to make an honest assessment about how they would react to another painful short-term downturn and in the process reaffirm their asset allocations.

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Though uncertainty is high, we want to emphasize that we are focused on meeting the challenges of navigating this environment and taking advantage of the opportunities that it presents. In addition to analytical expertise, conviction, and patience, we think our ability to do this successfully requires that we expand our knowledge base and stay intellectually honest by challenging our own views. These are all core elements of Leavell Investment Management's research process. They have been critical to our past success and, we believe, bode well for our ability to continue to add value for you in the future.

We appreciate your confidence. Please contact us to discuss any questions or your individual situation.

Best regards,

A handwritten signature in dark red ink, appearing to read "Timothy S. Healey".

Timothy S. Healey
Chief Investment Officer
Leavell Investment Management, Inc.