

Fourth Quarter
2008



Investment Commentary

2008 was certainly the worst year for the U.S. stock market since 1931. The Standard & Poor's 500 Index posted a total return of negative 37.0% for the year, its worst performance since the index declined 43.3% in 1931, some 77 years ago. The Nasdaq Composite Index fell 40.5%, the worst percentage decline in its 38-year history, surpassing the 39.3% plunge as the tech stock bubble burst in 2000. There was no place for investors to hide. Almost every asset class was in the red for the year. The lone positive spot was U. S. Treasury Bonds which benefitted from a flight to safety as investors avoided virtually any and all risk. The year was certainly the most difficult period in the 29-year history of our firm.



The rapidly deteriorating economy combined with investor behavior that was often disconnected from fundamentals made investment decisions extremely challenging during the latter half of the year. As the year progressed and the credit crisis deepened, major financial institutions' lending function seized and the money markets were freezing up. It soon became apparent that the financial storm on Wall Street was something that had not been experienced in any of our lifetimes.

The scope of the devastation in financial markets was pervasive. Bear Stearns, Lehman Brothers, Wachovia and AIG failed as the conventional investment banking business model crumbled. The government took over the operations of Freddie Mac and Fannie Mae. The Federal Reserve cut its key interest rate seven times, ending the year at 0.0% - 0.25%, a historic low. The demand for U.S. Treasury notes led to a 0% yield as investors

sought safety at the expense of return. As we ended 2008 we learned of an enormous Ponzi scheme that had taken investors to the tune of some \$50 billion.

With consumers forced to pay down debt and increase savings, it is quite possible that the current recession will be lengthy and deep, followed by a weaker-than-normal recovery. Private and public debt has been growing for more than 20 years and it is going to take some time to de-leverage. It is impossible to say that the stock market low in late November will be the eventual bottom of the market.

This is the fifth (and most severe) recession we have navigated in our 29-year history and we have found that very difficult market environments have ultimately presented opportunities that can reward systematic and disciplined investment management. When you review each historical downturn, our system has survived and thrived. We do not believe that this one will be different.

Historical comparisons are sometimes helpful in assessing where we are in an investment cycle. There have been two extreme economic/investment environments in the last 80 years – the 1930's and the 1970's/early 1980's. We are all familiar with the financial, economic and human devastation that accompanied the Great Depression of the thirties. In the early 1980's inflation was sky high, interest rates were in the teens and we suffered from back to back recessions with unemployment exceeding 10%. In both periods investor confidence was crushed. But as it turned out, both periods presented a great opportunity for long-term investors to buy stocks. Investors always face uncertainty and usually have conflicting signals to analyze

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when making investment decisions. Experience would suggest that when risk seems at its greatest it is usually a good time to invest and when returns are comfortable investors are likely to be disappointed going forward.

Governments around the world have made it clear that they will do whatever it takes to support their economies, yet credit markets, though slightly improved, remain dysfunctional. We seemingly have avoided a financial system collapse, but the consumer, attempting to reduce debt and increase savings, could lead to an extended economic downturn as the deleveraging cycle runs its course.

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Monetary and fiscal stimulation usually lead to high levels of inflation. Thus bond maturities must be managed. We continue to construct bond portfolios with a laddered structure and with emphasis on mid range average maturity to mitigate any consequences of a flare-up in inflation. Municipal bonds are trading at particularly attractive levels. Technical factors hit the muni market which reduced demand from some typical buyers and forced selling from hedge funds and mutual funds. Stressed municipalities (e.g., Jefferson County, AL) and other tax-exempt issuers have also raised fears of defaults in the market. It should be noted that defaults have been rare. We continue to focus on the higher quality issues in the municipal market to protect our portfolios from credit risk.

We believe we are well-equipped to navigate this turbulent and potentially rewarding environment with our professional approaches to stock and bond investments. At times like these, discipline becomes a critical element of a sound investment philosophy. It will take some time to make up the losses of last year. However, as noted previously, positive returns have always resulted for those who “stay the course” with a realistic and measured approach.

We appreciate having clients who continue to express confidence in the work we do. We remain strongly committed to achieving your investment objectives. Please contact us at any time to discuss any questions or concerns.

Best Regards,

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Chief Investment Officer
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