



Lodestar

Investment Commentary on the Quarter Ended September 30, 2008

For some time, we have expressed unease over the immense buildup of debt throughout the economy and financial system, and with the complacent attitude of investors, regulators, and politicians with regard to risk. With respect to the markets, a principal concern has been the influx of funds, coming from both individuals and institutions, into a number of untested strategies. Many of these programs incorporated the lethal combination of newly created assets and significant financial leverage. While it was impossible to predict how or when securities markets would react to this hazard, the historical record suggested that the response could be quite destructive. Unfortunately, the current environment clearly proves that neither equity valuations nor fixed-income spreads offered sufficient margins of safety for investors generally.

This past quarter, and now continuing into October, witnessed a swift unwinding of many of the excesses built up in recent years, and the undoing of some of America's most historic financial institutions, including Fannie Mae, Freddie Mac, Lehman Brothers, AIG, Merrill Lynch, Washington Mutual and Wachovia Bank. The intensity and acceleration of the downturn has been unnerving and indiscriminate, taking virtually all assets into bear market territory. It is not simply investors in 'risky' assets who are suffering. For the moment, credit availability has all

but dried up; debt markets have largely ceased to function, bank loans are not available to many and, indeed, banks do not have confidence in one another.

While 'globalization' has allowed for free flows of capital to all corners of the earth, these flows have been severely restricted of late, a condition that now presents a huge challenge to the world economy. As noted, on many occasions we have discussed the dangers inherent in high debt levels. One segment of the investment world that took advantage of cheap and plentiful credit was the hedge fund community, those investors who claimed to thrive in both good markets and bad. It is now clear that their impact on the rest of us has been broadly destructive, as the debt they used to goose returns during good times is no longer available. Margin calls and redemptions are requiring forced liquidation after forced liquidation. In hindsight many of these hedge fund investments were nothing more than leveraged trading strategies and, sadly, their unwinding is wreaking havoc on investors, savers and the economy.

The Markets

Stocks and bonds were little changed during July and August, as most market participants viewed the credit crunch as a manageable problem, and major financial challenges had yet to spill over to Main Street. Commodities, particularly energy, had given up some

of their gains, but the declines were orderly. **The government's seizure of Fannie Mae and Freddie Mac, followed by its decision to allow Lehman to file for bankruptcy, changed the perception of many investors as to the level of risk in the marketplace.** Lost confidence led to a lack of liquidity which, in turn, drove down asset prices and set off the aforementioned wave of selling. The economy also began to sour and other investors sold on the prospects for weakening corporate profits. By the end of September, US stocks were down approximately 24% for the year, foreign stocks 32%, and emerging markets almost 40%. Losses in US stocks were disappointing, yet all but three international markets (Turkey, Philippines and Peru) were worse. In fact, of the 61 countries in the Dow Jones Global Index, none were up in the quarter just ended and 37 were down more than 20%, versus the roughly 9% decline for the S&P 500 index.

September was one of the most volatile and disparate months ever in the fixed income market. Due to an extraordinary 'flight to quality', securities associated

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with the federal government (including treasuries and agency debt), performed well at the expense of most everything else. A high credit rating counts for little these days and prices for even high quality bonds have been marked down, often to fire sale prices. Many investment grade corporate bonds, and to a lesser extent municipals, have suffered declines, partially due to credit concerns, but also because of the fund liquidations and turmoil in the money markets. Reflecting the panic, the yield on various treasury bill maturities was negative for a brief time in September, meaning investors were actually paying the government to hold their money.

A Brief Description Of This Mess

The evolution of this financial crisis is broadly familiar, but it might be helpful to put the world of CDO's, SIV's, and credit default swaps into plain English, or something approaching that goal. **Lax regulation, greed, and excessive debt are the root causes of the current instability.** It started with government legislation aimed at encouraging homeownership among the economically less fortunate and, over time, morphed out of control. Bad mortgage loans were made to people who

could not afford them under reasonable circumstances. Wall Street packaged these loans and sold them to investors (hedge funds, pension managers, etc.), providing handsome yields to buyers, and fat fees for themselves. This activity took off as new mortgage 'products' were unveiled (no doc, option arm, among other types of loans). A variety of financial players provided insurance to protect investors against default by the underlying mortgages. Aiding and abetting this process were the rating agencies that used 'sophisticated' computer models to award triple A ratings to these investments. Many of

us wondered, aloud and in print, how these supposedly AAA rated securities could yield significantly more than other AAA rated investments, but that stopped no one as the housing market soared and Wall Street reaped billions in profits.

By now, most everyone is familiar with the subprime crisis, as banks have written off billions in bad loans. A larger problem, because it has created so much

uncertainty, is the interconnection among financial companies. Once home values started to decline, a waterfall of negative events ensued. Due to a recently enacted accounting rule, banks were forced to mark these troubled, illiquid investments to market, meaning the investments needed to be valued at the most recent price for a similar security that had actually traded. Having already taken huge losses, and now carrying assets at significantly reduced levels, banks were required to raise capital in order to meet regulatory guidelines. At first, new money was available but, when market conditions worsened, the only way to generate additional capital was to sell assets. As you can see, this situation quickly deteriorated into a 'dog chasing its tail' scenario. **The magnitude of the problem, and the inability to realistically value these illiquid securities, caused the financial system to seize up and essentially stop functioning.** A run on the bank caused the failure of Washington Mutual, and further panic followed when the oldest money market fund in the country 'broke the buck', something that few could have fathomed. All of the uncertainty has led many of the world's major banks to stop lending to one another or, if they do, to charge much higher rates. Confidence has vanished.

Where Do We Go From Here?

The economy is weak and becoming more frail by the day. Hard and anecdotal evidence suggests that businesses are now feeling the brunt of the credit crunch. Few doubt that we are in a recession. Orders have been delayed, hiring plans suspended, and transactions put on hold. Unemployment is likely to rise and consumer spending will slow. **While the stock market gyrations receive much of the attention and headlines, the more pressing problem lies with the clogged credit markets. Until rational lending and borrowing resume, financial markets generally, and economic activity broadly, will remain under pressure.**

While the stock market gyrations receive much of the attention and headlines, the more pressing problem lies with the clogged credit markets. Until rational lending and borrowing resume, financial markets generally, and economic activity broadly, will remain under pressure.

Recessions are part of the business cycle, but depressions are not. Some are pointing to the 1930's when analyzing current circumstances. While very concerned, we do not believe a depression lies in our future. The Great Depression occurred because policy makers made huge mistakes after the economy faltered. This time around, US and global monetary authorities are doing everything possible to cushion the downside, providing liquidity in many forms and, now, attempting to stabilize markets with the recently designed bailout/rescue plan. While we are philosophically opposed to government intervention, one must be practical in times of severe distress. No one should think that this legislation is a bailout of rich Wall Street executives - while they may benefit, it is Main Street that will be helped most. If conducted properly, the Treasury's plan should, over time, encourage the credit markets to work again, allowing business and the consumer to regain confidence. Liquidity issues have been at least partially resolved. The problem now is that few lenders have sufficient faith to put the funds to work. Renewed confidence should allow this bunker mentality to diminish.

Markets of all kinds now reflect much of the damage inflicted by the credit crises. Commodity prices have collapsed and, as noted, credit spreads (the yield difference between treasury and non-treasury bonds) are exceedingly wide. As we write, the Dow Jones Industrials are 40% off their record highs of October, 2007. To put this in context, since 1901 the average bear market decline has been approximately 30%, meaning that we are already well along in the cleansing process. Of course, stocks can go down from here, as many previous contractions have, but there is clearly a great deal of bad news now incorporated in prices. While earnings estimates will decline and P/E ratios are not screamingly cheap, other measures suggest that many stocks offer solid long-term value. **Though no one can predict 'the bottom', we believe that, looking over the current**

canyon of despair, the stocks of great companies will ultimately prove to be rewarding investments from current levels. Again, we will be watching the credit markets carefully for clues as to when this difficult period will end. When the yields on fixed-income securities, other than treasuries, return to normal levels, and credit spreads decline, we will know that the financial system is functioning again.

Bottom Line

The events of the past several months have been very disconcerting, and there is no way to diminish the severity of the challenges facing our society, economy and markets. While we have tried to be cautious in our outlook, and encouraged conservative asset allocations that reflect our client's circumstances, there has been little room to hide from this market tumult. Having said that, we have long discussed, and firmly believe in, the notion of buying great companies at great prices. During times when many investors lose their nerve, we (collectively you and us) must keep ours. **The market will bottom when the news flow is bleak, and after most have already sold. For those investors whose risk tolerance and financial circumstances allow, we should move cautiously, but firmly, to increase equity exposure as stocks become better values.**

Over long periods, it is indisputable that stocks have provided better returns than any other investment class. While patience and fortitude will be needed, this time should not be different.

We have long preached the virtues of quality, income, and portfolio balance. Good quality companies will survive this convulsive period, and many will emerge stronger. Income can be counted on when capital gains are not achievable. Balance is critical because it allows for resisting the emotionally driven actions that are usually counterproductive. Never have these lessons been more important to remember. ☆

Though no one can predict 'the bottom', we believe that, looking over the current canyon of despair, the stocks of great companies will ultimately prove to be rewarding investments from current levels.

Managing Director Profile

William A. Goldstein, Chairman

Bill has 46 years of experience in the financial services industry. He founded Lodestar in 1989 after holding the Chairman and Director position of Prescott Asset management, a wholly-owned investment advisor of Prescott, Ball & Turben, Inc. Prior to that, Bill was a founding principal, Executive Vice President and Director of Burton J. Vincent, Chesley & Company. The firm was acquired by Prescott, Ball & Turben, a Kemper Corporation subsidiary.

Bill graduated from Purdue University with a Bachelor of Science in Industrial Economics.

Bill volunteers as a member of the Endowment and Investment committees for the Evanston Community Foundation and the Chicago Symphony Orchestra. In addition, he serves on the Boards of Trustees of the Chicago Symphony Orchestra and the Night Ministry. Bill also is an avid bicyclist and sailor.

Bill can be reached at 312.630.9666 or at bill@ldstr.com

Market Snapshot – September 30, 2008

Equity Indices	Quarter	YTD	Interest Rates	09/30/08	09/30/07
S&P 500	(8.49)%	(19.43)%	5-Year Tax-Exempt AA	3.40%	3.59%
Dow Industrials	(3.72)%	(16.59)%	5-Year US Treasury Notes	2.98%	4.17%
NASDAQ	(8.77)%	(21.13)%			
Wilshire 5000 Index	(9.16)%	(19.87)%	Commodities		
			Gold (\$/oz.)	\$884.50	\$743.00
			Oil—WTI (\$/Barrel)	\$100.64	\$81.67

“Lodestar”: 1 A guiding principle, interest, or ambition. 2. A star, especially Polaris, that is used as a point of reference.

Lodestar Investment Counsel was formed in 1989, as an independent registered investment advisor, with the above definitions firmly in mind. All of our principals have extensive experience working with high net worth individuals, families, corporate and individual retirement plans, and charitable organizations, like those who make up our client base today.

We recognize and respect the need to grow and preserve our clients’ core assets. Our services are designed to provide a risk-averse approach to long-term capital appreciation, that is tailored to the unique financial circumstances and needs of each specific investor. We provide discretionary account

management for taxable, tax-exempt, balanced and fixed-income portfolios.

To assure that all our clients receive a high level of personal service, our minimum account is \$1 million in investable assets. In all aspects of our business, we strive to adhere to the guiding principles of focus, consistency and service.

We would welcome the opportunity to meet with you, or others you know who might benefit from our services. Thank you for your consideration.

Robert H. Dearborn

Peter W. Flanzer

William A. Goldstein

John J. Sobel