



Lodestar

Investment Commentary on the Quarter Ended December 31, 2008

2008 ended with a whimper after a fourth quarter that few will forget. A cascade of negative events during the second half of the year created considerable strain on the world financial system, leading to the worst annual stock market performance in the US since the Great Depression. Extreme volatility became the norm as stocks, bonds, and commodities, both in developed and emerging markets, suffered mightily. The events that led to the fourth quarter meltdown were long in the making, though the ferocity and speed of the unwinding were wholly unpredictable. Recognizing, to be sure, that asset values declined markedly in 2008, it is worth noting that conservative investment principles, including quality, portfolio balance, and income generation helped to cushion the downside somewhat.

Without dwelling too much on the gory details, we should review how this unfortunate story unfolded. For years, virtually non-existent credit standards had fueled bubbles in real estate, mortgage-backed securities and other assets. **Rising delinquencies and defaults on loans, together with mark to market accounting, forced massive asset write-downs at financial institutions globally, a virtual freezing of the credit markets, unprecedented credit spreads (the incremental percentage yield over US treasury securities) for most debt securities, and a stock market melt-down.** Eventually, balance sheet strains and an inability to raise capital led to a

crisis of confidence in both individual financial institutions and the system as a whole. Lehman Brothers' September bankruptcy was the tip of a financial iceberg that led to widespread panic. Fear took on a life of its own, eventually causing some to question the viability of the global financial system. **The bottom line is that excessive leverage, speculation, greed and lax regulatory oversight brought the financial world to the edge.**

Fear and failure, on and of Wall Street, caused waves of security sales as mutual funds met redemptions, hedge funds repaid debt, and frightened investors took to the exits. **The S&P 500 lost 23% in the fourth quarter, and 37% for the year, representing its largest negative return since 1931.** At the low point (November 20th) the S&P was down 47% for the year. While no one needs convincing as to the severity of this bear market, only 26 (5%) of the S&P's 500 companies were higher for the year, and 2 of the 30 Dow Jones Average firms closed with gains. **Though 'best of breed' stocks performed better than most, this was little comfort as many mutual funds lost half or more of their value.** Despite seeing the largest destruction of absolute wealth in history, US equities actually fared better than most other global markets, though all were victims of the unfolding credit crisis and global recession.

While stocks received most of the attention during their waterfall from grace, it was the credit markets

that provided the most startling story. Yield spreads on all kinds of debt widened dramatically in the fourth quarter as liquidity and credit concerns, together with a huge helping of forced selling, drove prices down. Some of the selling related to investor concerns about a rapidly deteriorating economy. Equally responsible, in our view, for the massive liquidation were the huge debt loads utilized by many current fixed income investors. Historically, corporate bonds were owned largely by insurance companies, pension funds, and other 'buy and hold' investors. More recently, hedge funds and other speculative investors have borrowed at dirt cheap rates and used that leverage to buy bonds with higher yields than their cost of capital. As with stocks, these 'fast money' managers were compelled to sell as bond values plummeted and redemptions surged. Much of the proceeds from the panic selling of both stocks and bonds were parked in US Treasury securities, driving their yields down to near zero on short maturities, and to historically low levels on the long end.

With reason having given way to emotion in recent months, it seems prudent to dispassionately review what we know and

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what we don't, and then to provide some thoughts as to where the economy and markets may be going.

What We Know

- US and global economies are embroiled in deep recessions, as manufacturing, consumption, sentiment and job loss indicators all reside at levels not seen since the nasty downturn of the early 1980's. The Congressional Budget Office is projecting a 2009 federal government deficit of \$1.2 trillion, before accounting for the \$700 billion TARP program and President-elect Obama's stimulus plan, thought to total another \$1 trillion. The basic deficit of \$1.2 trillion amounts to 8% of GDP, the highest figure since 1945.
- Current conditions are not remotely close to those of the Great Depression. GDP fell by 30% through those years; in the current downturn, GDP is down less than 5%. During the 1930's, authorities raised interest rates and unemployment reached 25%. Currently, interest rates are near zero, and unemployment is 7%. Moreover, for the moment, taxes have not been raised nor trade barriers imposed, as they were during the early 1930's.

The bottom line is that excessive leverage, speculation, greed and lax regulatory oversight brought the financial world to the edge.

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- US and foreign monetary authorities have enacted dramatic interest rate cuts and announced unprecedented intervention and stimulus plans in order to stave off a collapse in the global financial markets and, eventually, to rebuild economies worldwide. A fear of inflation just six months ago has been replaced by one of deflation.
- Credit spreads have narrowed since the October-November panic, but remain at distressed levels. At their peak, low investment grade corporate bonds were discounting greater than 25% default rates, and offered yields over comparable Treasuries of approximately 7%. Bond investors have not witnessed these levels in many decades.
- S&P 500 earnings will be down approximately 20% in 2008 from the prior year, and profit estimates are now negative for the next 12 months; ironically, this condition has been bullish for stock prices in the past.
- The dividend yield on the S&P 500 Index exceeds that of the 10-year Treasury note for the first time since 1958.

Prior to that date, stocks always offered higher yields than bonds as they were deemed more risky.

- Of late, many great companies have been valued at less than 12 times trailing earnings, a condition not present since the mid-1990's. Valuation provides the ultimate margin of safety for the long-term investor.

What We Do Not Know

- The extent to which massive, worldwide government intervention will stabilize and/or repair broken economies and markets. In this vein, how much more "deleveraging" is necessary and, are US Treasuries forming a new "bubble"?
- Have asset prices discounted the worst of the economic and financial crises, or are there more to come? More specifically, will valuations revisit the historic lows set in the 1930's and 1973-1982 time periods?
- Will unprecedented levels of government stimulus have negative consequences down the road? Similar actions in the past have led to a lower currency, higher inflation and interest rates, and a reduced standard of living.
- Will free market capitalism survive in the US, or will government bailouts and spending programs, tighter regulation, higher taxes, and political correctness move us towards a European style managed economic structure?
- Will this experience encourage a return to sound economic and investing principles – hard work, real savings, less conspicuous consumption, living within our collective means, a focus on risk as well as reward?

Observations

For years, we have written about the extensive and dangerous use of debt by individuals,

government, and investors alike, as well as the complacency toward risk that existed on the part of too many. Still, the financial carnage that took place in 2008 exceeded our expectations, to say the least. Although we did not sell into the panic, it was stressful watching others do so, knowing that our portfolios were caught in the downdraft. While economic problems remain enormous, we are hopeful that the worst of the news flow has passed, and that the indiscriminate selling that was so pervasive during the latter part of 2008 is mostly over. Should this notion prove misguided, **historical precedent still suggests that meaningful stock market rallies are likely this year. Even the worst secular bear markets of the past have experienced 'dead cat' bounces of 30-50%.** On a longer term basis, it is comforting to note that after the ten largest stock market declines in history, the annualized returns over the ensuing five years have been positive, many sharply so.

No doubt, there are an unusual number of worrisome issues these days. This is truly a global recession, with trade plummeting and signs of deflation evident throughout the world. Too much productive capacity was created during the conspicuous consumption years, and now there are too many houses, cars, restaurants and retail establishments. There is excessive debt through all walks of society, and not enough savings. A retrenching consumer may prolong the current recession, and result in higher unemployment, as many businesses are likely to fail this year. Lastly, the Federal Reserve is penalizing savers by forcing interest rates to near zero, and is explicitly encouraging risk taking, the same policy that created the difficulties we face today.

Longer term, the implications of mass government intervention, widespread regulation, and control of several critical industries are not positive. Dangerous precedents are being set, and history illustrates that heavy public sector influence is not favorable for either economic or financial

market health. **While extensive government intrusion is understandable in light of the uncharted difficulties, future consequences may include a devalued currency, higher inflation and rising interest rates.**

China recently stated that its "increased purchases of US Treasury Securities should not be interpreted as an endorsement of the assumption that the US can borrow its way out of the current financial crisis". Should China and/or other large holders shy away from US debt, meaningfully higher rates will likely result. On a macro level, history holds many lessons for investors. One is that periods of global asset liquidation and contraction often result in rising geo-political tensions, and economic policies that benefit one country at the expense of others. In fact, many countries are already enacting protectionist policies.

Despite all of the gloom, opportunities often arise out of chaos. **While providing a forecast for 2009 is pure guesswork due to the unsettled times, we can say with confidence that many high quality stocks and bonds offer the prospect of outsized returns over coming years.**

Equities in particular are dramatically cheaper than they have been in years, with some very strong companies now providing generous dividend yields. Though many investors are understandably nervous about adding to equity exposure at this time, markets always form bottoms when fear and panic reach extreme levels. By many indications, that level was reached in November.

The general consensus among investors that things can only get worse from here is typical of a durable market trough. In short, while the economy will be challenging for the foreseeable future, the financial markets may ultimately perform well given the current environment of low expectations, negative sentiment, and attractive valuations. The current backdrop may feel uncomfortable, but history suggests that strong investment returns are rewarded to those with the patience and discipline to weather market storms such as we are currently enduring. ☆

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Managing Director Profile

Peter W. Flanzer
Managing Director

Peter joined Lodestar in 2002 after serving as a Principal with another Chicago-based investment advisory firm. For over 20 years, his focus has been on working with private clients in the management of their investment portfolios.

Peter earned his bachelor of arts degree from Kenyon College, and received his law degree from the John Marshall Law School in Chicago.

In addition to spending time with his family and participating in civic and charitable affairs, Peter is an avid golfer in the warmer months and enjoys playing paddle tennis in the winter.

Peter can be reached at 312.630.9666 or at Peter@ldstr.com.

Market Snapshot – December 31, 2008

Equity Indices	Quarter	YTD	Interest Rates	12/31/08	12/31/07
S&P 500	(18.30)%	(37.03)%	5-Year Tax-Exempt AA	2.59%	3.32%
Dow Industrials	(18.40)%	(31.93)%	5-Year US Treasury Notes	1.54%	3.53%
NASDAQ	(24.61)%	(40.54)%			
Wilshire 5000 Index	(23.48)%	(38.68)%			
			Commodities		
			Gold (\$/oz.)	\$869.70	\$833.70
			Oil—WTI (\$/Barrel)	\$44.60	\$96.00

“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