



Montecito Private Asset Management, LLC

MPAM

INVESTMENT MANAGEMENT SEMINAR

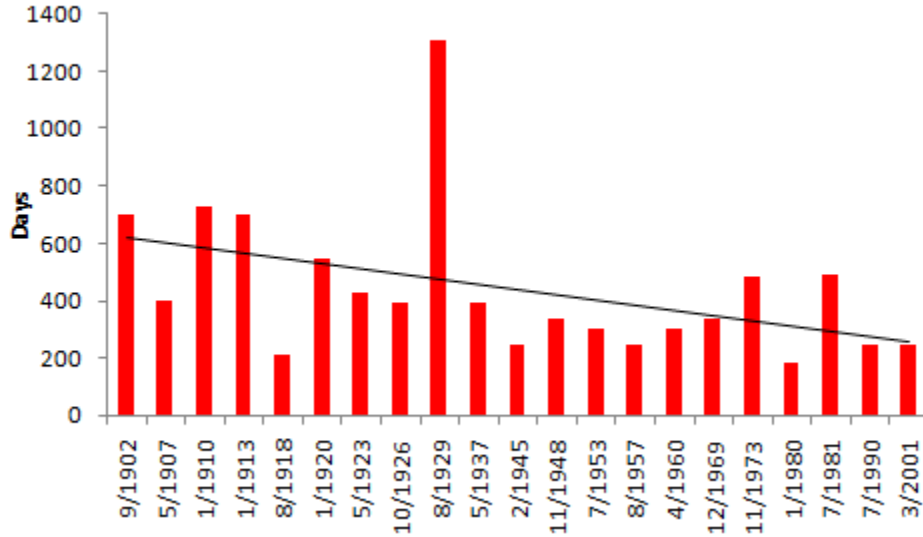
HISTORICAL PERSPECTIVE

Two thousand eight was a very challenging year. So how did we get here?

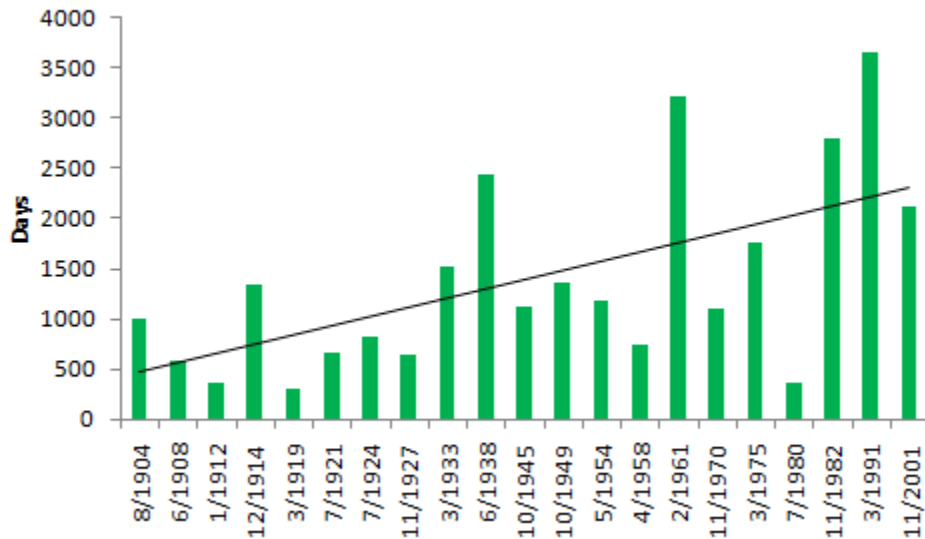
- **Massive speculation in real estate** fueled by low interest rates and lax lending standards at banks, coupled with further speculation by financial institutions in the mortgage-backed securities and credit default swaps (CDS) markets, led to a huge expansion of debt throughout the world.
- Once real estate values started to fall, the party was over; financial institutions could no longer find buyers for their mortgage-backed securities portfolios, resulting in that market collapsing. This **deleveraging in the real estate and related securities markets**, resulted in extremely large losses (hundreds of billions of dollars) for many financial institutions around the world, and especially here in the United States, culminating in the **failure or near failure of Bear Stearns, AIG, Lehman Brothers, Merrill Lynch, Citi, and the like.**
- Along the way, individual homeowners, some of whom were conned by unscrupulous mortgage brokers, many of whom simply gambled, over extended themselves, and have started to lose their homes to **foreclosure.**
- As a direct result, we have seen stock market valuations get cut in half, and as a result, investors have lost approximately \$5 trillion in stocks alone. Additional substantial losses have occurred in the tax-free and corporate bond markets.
- We also witnessed massive speculation in **commodities** during the first half of 2008, with oil forming a bubble, hitting its peak in mid-2008 around \$147 per barrel before collapsing and ending the year around \$43 per barrel; a 70% drop from the peak.
- Finally, we also experienced a massive flight to safety, especially during the fourth quarter, as investors exited stocks, commodities, and real estate-backed securities where they could, and bought cash equivalents; mainly **U.S. treasuries.** We now have a massive bubble in treasuries, which will burst at some point, as happens with all bubbles.
- In response, the treasury and Fed took unprecedented steps to combat the negative impact on the financial markets and economy, including gigantic amounts of liquidity injection, lowering rates to zero percent, and the \$700 billion TARP (Troubled Asset Relief Program). The stated purpose of the **TARP** was to use funds to buy mortgage-backed securities to take them off the balance sheets of the banks and unfreeze that market. As we know, Treasury did not use the money for that purpose, and we are all suffering the consequences of this mistake or deception, depending on your point of view.
- Finally, the biggest mistake of all was allowing **Lehman Brothers** to fail, which sparked a classic run on the bank, driving fearful investors to pull money from money

markets, banks, stocks, bonds, and everywhere else, which led to the large drops in stocks we saw during Q4.

Duration of Recessions: 1900 - 2007



Duration of Expansions: 1900 - 2007



So that we may put 2008 in context, I will present some historical data below. In the first table, I show the performance of the ten sectors of the economy, as per Standard & Poors.

SECTOR	12/31/2007	12/31/2008	2008 SECTOR PERFORMANCE	12/31/2007 WEIGHTING IN S&P 500	12/31/2008 weighting in S&P 500	CHANGE IN S&P 500 WEIGHTING YOY
Consumer Discretionary	259.53	169.41	-34.72%	8.18%	8.40%	2.69%
Consumer Staples	299.55	246.66	-17.66%	10.59%	12.88%	21.62%
Energy	603.04	386.35	-35.93%	12.90%	13.34%	3.41%
Financials	392.08	168.79	-56.95%	17.43%	13.29%	-23.75%
Healthcare	409.7	309.41	-24.48%	12.98%	14.79%	13.94%
Industrials	354.35	207.21	-41.52%	11.27%	11.08%	-1.69%
Information Technology	411.62	231.81	-43.68%	15.91%	15.27%	-4.02%
Materials	259.84	137.59	-47.05%	3.35%	2.93%	-12.54%
Telecommunications	168.26	111.7	-33.61%	3.54%	3.83%	8.19%
Utilities	216.11	147.93	-31.55%	3.85%	4.19%	8.83%

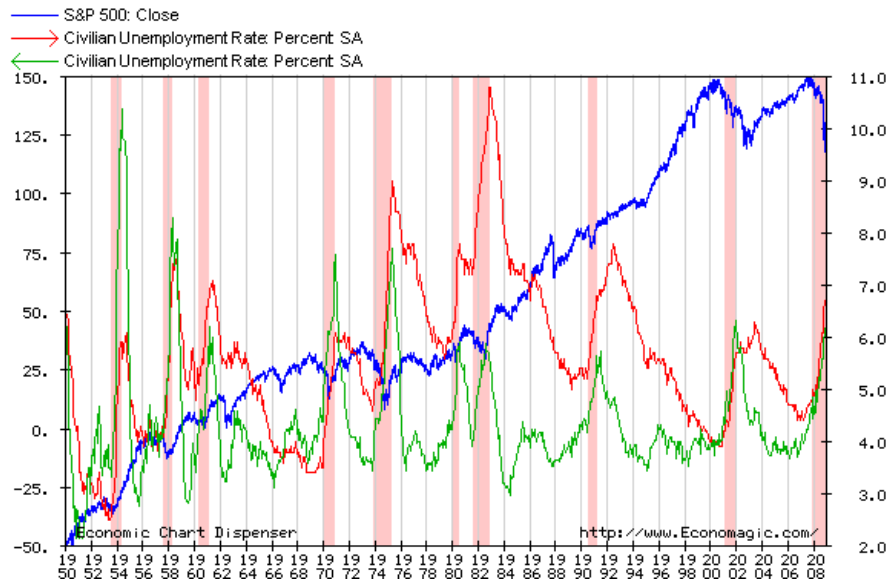
Real Estate

The national median new home price fell 9.3% from December 2007 through December 2008, to \$206,500. Existing home sales fell 13.1% during 2008, inventories are coming down, now at a 9.3 month supply, and the existing home price (national) fell by 14.8% (single family home price), from \$207,000 in December 2007 to \$175,400 at the end of December 2008. Existing-home sales in the West jumped 13.6 percent to an annual rate of 1.25 million in December and are 31.6 percent higher than a year ago. The median price in the West was \$213,100, down 31.5 percent from December 2007. In Santa Barbara, the median home price for existing single family homes rose from \$835,000 in December 2007 to \$952,500 in December 2008, or by 14%. However, from October 2007, the median home price has fallen from \$1,275,000, or by 25%.

Unemployment

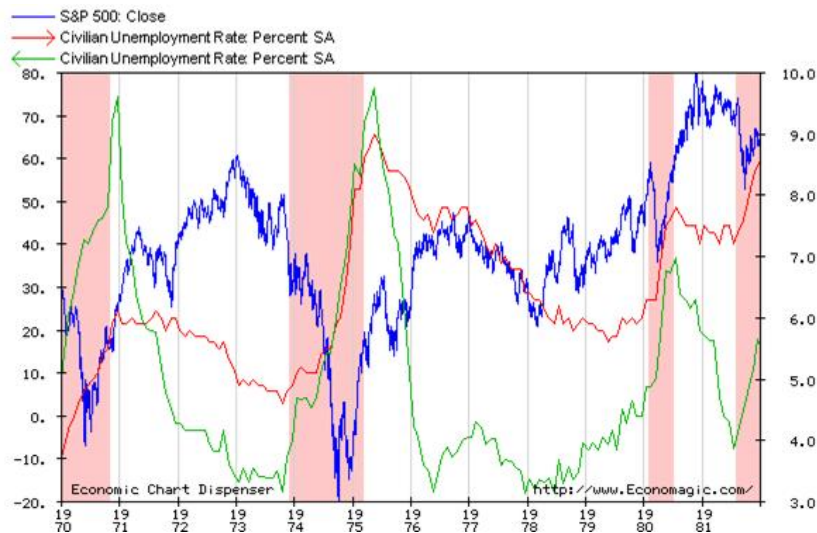
We lost 524,000 jobs in December, 1.5 million during the fourth quarter, and almost 2.6 million in 2008. The total jobs lost for 2008 was 2,589 million, which represents *1.67% of the total U.S. workforce*. While the total number lost (2.6 million) is close to the number lost in 1945 (2.75 million), as a percentage of the workforce, it is not that close, since in 1945, the 2.75 million jobs lost represented *5% of the total workforce*. Still, it's a lot of people out of work. In 1982 we lost 2.1 million jobs, which represented about *2.1% of the workforce*. So in context, while 2008 was certainly a bad year and a lot of jobs were lost, historically speaking, it wasn't as bad as it might seem otherwise.





The chart above shows a very interesting comparison between the S&P 500 and the unemployment rate. The blue line is the S&P 500, the red line is the unemployment rate using the right scale, and the green line is the percentage change of the unemployment rate versus a year earlier using the left scale, while the pink vertical bands represent recessions. The point of this chart is that during recessions, you can see unemployment spike and stocks hit bottom, followed by reduced unemployment and strong stock market rallies. Often, stocks hit their bottom during the recession, and have already begun rallying long before unemployment peaks. I believe we will see this happen during the current recession as well.

The chart below is an expanded view of the same data, but for 1970 through 1982 or so. You can see much more clearly in this chart how stocks make their bottoms during the recessions, while unemployment doesn't peak until after the recession ends. This chart also includes the 1974/75 period, which was a really ugly recession, and can be compared with what we are going through now.



Index performance

The 2008 calendar year witnessed some of the worst performance for stocks in our history. It was the third-worst year for the Dow and S&P 500 since their inceptions, and This next series of tables shows the performance of the major indices going all the way back to their inceptions.

INDEX	YEAR OF INCEPT.	1903	ONE YEAR LATER	5 YEARS LATER	1907	ONE YEAR LATER	5 YEARS LATER	1914	ONE YEAR LATER	5 YEARS LATER
DJIA	1896	-23.61%	42.64%	75.42%	-37.73%	46.64%	49.57%	-30.72%	81.66%	96.46%
S&P 500	1918	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
NASDAQ COMP	1971	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
RUSSELL 2000	1987	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A

INDEX	1917	ONE YEAR LATER	5 YEARS LATER	1920	ONE YEAR LATER	5 YEARS LATER	1929	ONE YEAR LATER	5 YEARS LATER	1930	ONE YEAR LATER	5 YEARS LATER
DJIA	-21.71%	10.51%	31.98%	-32.90%	12.30%	117.73%	-17.17%	-33.77%	-58.10%	-33.77%	-52.67%	-12.43%
S&P 500	N/A	N/A	N/A	-24.53%	7.40%	51.96%	-11.91%	-28.48%	-55.71%	-28.48%	-47.07%	-12.45%
NASDAQ COMP	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
RUSSELL 2000	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A

INDEX	1931	ONE YEAR LATER	5 YEARS LATER	1937	ONE YEAR LATER	5 YEARS LATER	1973	ONE YEAR LATER	5 YEARS LATER	1974	ONE YEAR LATER	5 YEARS LATER
DJIA	-52.67%	-22.64%	130.94%	-32.82%	27.73%	-1.20%	-16.58%	-27.57%	-5.39%	-27.57%	38.32%	36.11%
S&P 500	-47.07%	-15.15%	111.58%	-38.59%	25.21%	-7.39%	-17.40%	-29.72%	-1.48%	-29.72%	31.55%	57.38%
NASDAQ COMP	N/A	N/A	N/A	N/A	N/A	N/A	-31.06%	-35.11%	27.97%	-35.11%	29.76%	152.66%
RUSSELL 2000	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A

INDEX	2000	ONE YEAR LATER	5 YEARS LATER	2001	ONE YEAR LATER	5 YEARS LATER	2002	ONE YEAR LATER	5 YEARS LATER	2008
DJIA	-6.18%	-7.10%	-0.64%	-7.10%	-16.76%	24.36%	-16.76%	25.32%	59.02%	-33.84%
S&P 500	-10.14%	-13.04%	-5.45%	-13.04%	-23.37%	23.54%	-23.37%	26.38%	66.89%	-38.49%
NASDAQ COMP	-39.29%	-21.05%	-10.73%	-21.05%	-31.53%	23.84%	-31.53%	50.01%	98.60%	-40.54%
RUSSELL 2000	-4.20%	1.03%	39.23%	1.03%	-21.58%	61.24%	-21.58%	45.37%	99.96%	-34.80%

Here are some bullet points on the tables above:

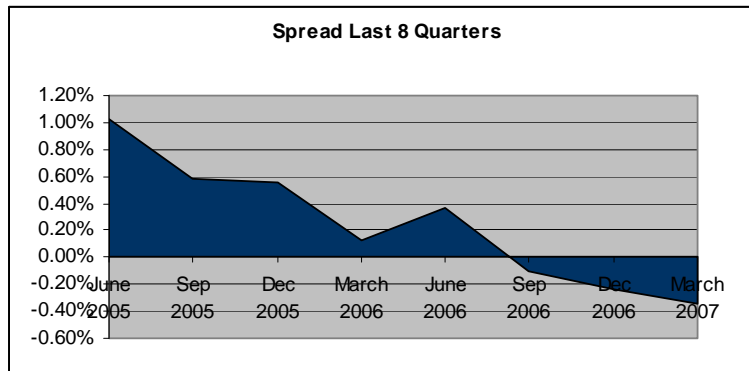
- The table show all years since inception, during which at least one index had a decline of at least 20% (I also added 1929, although surprisingly, both the Dow Jones and S&P 500 were not down 20% or more.
- The tables show performance for the indexes one-year out and five years out.
- In most instances, and especially if you take-out the initial three years of the Great Depression, stocks rebounded very sharply following a big losing year, especially over the following five years.

- Even looking at 1931, the third year of the Great Depression, stocks, over the next five years, had great returns, with the Dow gaining 131% and the S&P 500 increasing 112% over the five-year period.
- The 1973-75 time-period was one of the worst recessions in our country's history, and stocks did very poorly during those years. But, following 1974, stocks rallied big, especially the NASDAQ which had only been established three years earlier, and which gained 153% over the next five years (1975 through 1979).
- The more recent period of 2000 through 2002 (the bursting of the tech bubble) was also tough, but resulted in strong five-year performance from 2002 through 2007, a period of time which witnessed new, all-time highs for stocks and 100 percent returns for the NASDAQ and Russell 2000.
- For the Dow, of the thirteen years where we had at least one of the major indices down at least 20 percent, eight of those thirteen years the Dow was up the following year, and by an average of 14.27 percent. For nine of those thirteen years, the Dow was up over the following five years, and by an average of 69 percent.
- For the S&P 500, which was established in 1918, there were nine years in which at least one of the major indices was down at least twenty percent, and in those nine years, the S&P 500 was up the following year in four instances, and by an average of 22.64 percent. Looking at the five year period following the down year, the S&P 500 was up in five of those nine years, and by an average of 62.27 percent.
- While this data is hardly conclusive proof that we will rebound big in 2009, in the three years where the Dow or S&P 500 were down at least thirty percent, as we had in 2008, and excluding the primary years of the Great Depression during which stocks performed poorly (1929-1931), stocks rebounded sharply the next year all three times.
- **This year's performance was the third worst for the Dow and S&P 500 since they were established, and the worst since 1931 for the Dow and 1937 for the S&P 500. It was the worst performance for the NASDAQ since its inception in 1971, (even worse than 2000), the year in which the tech bubble burst. It was also the worst year for the Russell 2000 since its inception in 1987.**

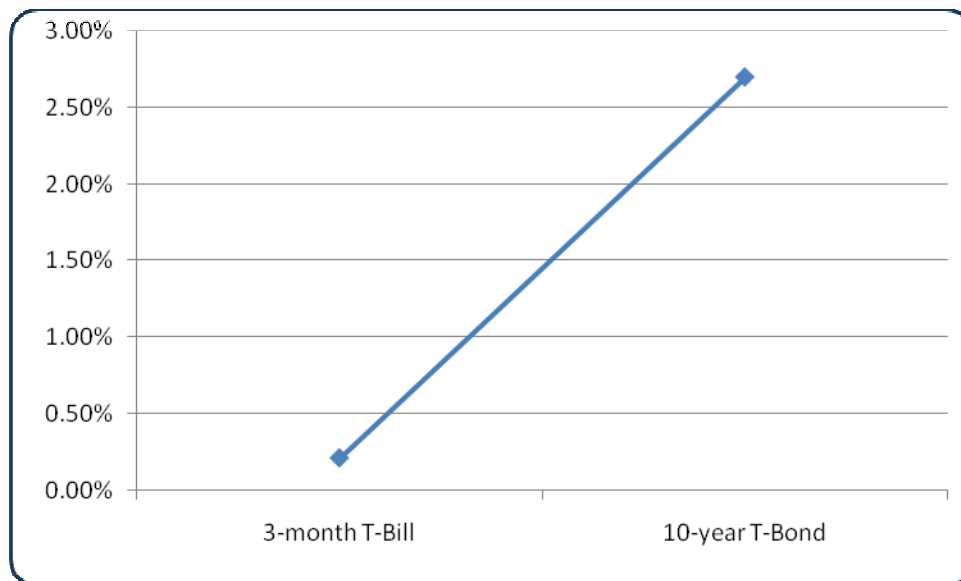
What I feel this data shows is that, for long-term investors, years of significant negative performance for stocks are typically followed by strong outperformance, especially given a five year time horizon. So the question on everyone's mind is: Are we going into another Great Depression, or is this just a normal bear market and economic recession? No one can know for sure, the answer to this important question, and I don't pretend to have all the answers.

However, there are some striking and important differences I can point to, which lead me to believe that we are not entering a multi-year, severe depression. Most significantly is the multi-tiered response of the government, which was completely absent in the early stages of the Great Depression. President Hoover believed that the free market should be left alone to work-out the problems of the day, and refused to act in any way to stem the tide of massive bank failures, the stock market collapse, and massive unemployment. By the time FDR took office, and despite the New Deal, the damage had been done, and most importantly, the confidence of the citizenry had been shattered. It really took World War II to pull us completely out of the Great Depression.

I would also point to two analyses I completed for my research piece entitled, “The Case for the Greatest Bull Market in History”, which is available free of charge on my website. The first is an indicator that I feel is the most accurate of all for predicting the direction of the economy. It is simple, but powerful. What I look at is the spread between the short and long end of the treasury yield curve. When the curve is inverted, as we saw in early 2007, the curve is forecasting a recession within the following four to eight quarters. When the yield curve is positively sloped (long rates are much higher than short rates), the curve is forecasting a recovery in the economy within the next four to eight quarters. Here is what the curve looked like at the beginning of 2007:



You can clearly see that the spread is below zero, indicating that *short rates were higher than long rates*; the curve was inverted. Here is what the yield curve looks like today:



As you can see, the yield curve is very steep, indicating a recovery in the economy within the next several quarters. When I wrote “The Case for the Greatest Bull Market in History”, on November 12, 2008, the yield curve was already very steep, and was actually steeper than it is today.

In the second analysis, I compared historical valuations of the S&P 500 to GDP. Here is the data:

YEAR	GDP	S&P 500 MKT CAP	RATIO: S&P 500 to GDP	YEAR- OVER- YEAR GAIN
1989	\$ 5.50	\$ 2.30	41.82%	
1990	\$ 5.80	\$ 2.20	37.93%	-7.00%
1991	\$ 6.00	\$ 2.80	46.67%	23.09%
1992	\$ 6.30	\$ 3.00	47.62%	5.44%
1993	\$ 6.66	\$ 3.30	49.55%	7.27%
1994	\$ 7.10	\$ 3.35	47.18%	-1.42%
1995	\$ 7.40	\$ 4.60	62.16%	33.24%
1996	\$ 7.80	\$ 5.75	73.72%	21.59%
1997	\$ 8.30	\$ 7.30	87.95%	27.82%
1998	\$ 8.75	\$ 9.90	113.14%	22.42%
1999	\$ 9.30	\$ 12.20	131.18%	15.60%
2000	\$ 9.80	\$ 11.60	118.37%	-10.69%
2001	\$ 10.10	\$ 10.40	102.97%	-14.94%
2002	\$ 10.50	\$ 8.25	78.57%	-22.53%
2003	\$ 11.00	\$ 10.00	90.91%	22.09%
2004	\$ 11.70	\$ 11.10	94.87%	6.84%
2005	\$ 12.40	\$ 11.40	91.94%	3.92%
2006	\$ 13.20	\$ 12.80	96.97%	12.94%
2007	\$ 13.80	\$ 12.90	93.48%	6.09%
2008	\$ 14.40	\$ 8.00	55.56%	-40.34%
2009	\$ 15.00	?	?	?

You can see that back in 1990 the S&P 500 dropped down below 38% of GDP, and from that year, with the exception of 1994, which was basically a flat year, the S&P 500 made a very strong, multi-year rally. When the value of the S&P 500 rose to above 100%, peaking in 1999 at 131% of GDP, the stock market peaked, and then began a bear market phase, coinciding with the bursting of the tech bubble. The S&P 500 dropped down somewhat to 78% of GDP value in 2002 at the market bottom, and from there we again rallied to just under 100% of GDP by 2007. In 2008, the S&P 500 fell again, this time to about 55% of GDP value, with the return on the S&P 500 showing more than a 40% decline.

From here, if history holds, we should see the S&P 500 rally back to 100% or more of GDP value, which would mean an S&P 500 level of at least 1,700. That would represent a gain from current levels of about 100%. That may seem crazy, but keep in mind that the S&P 500 was just above 300 in mid-1990, and rallied all the way to 1,576 at its peak in October 2007. That was a 425% gain. Even if it takes several years, I believe the potential for profits in the equities market far exceeds the potential in any other asset classes, especially over the next three to five years.

LOOKING AHEAD: 2009 AND BEYOND

Now that we have explored what happened last year and compared it with previous times of economic strife, let's look ahead to 2009. We will start with stocks. In the table below, I show the four major indexes with performance for 2008, and performance since the end of year 2008 through today's close. As you can see, we haven't had a very good start to 2009.

INDEX	12/31/2007	12/31/2008	% Change	1/30/2009	2009 YTD Change
DJIA	13,264.82	8,776.39	-33.84%	8,000.86	-8.84%
S&P 500	1468.36	903.25	-38.49%	825.88	-8.57%
NASDAQ COMP	2652.28	1,577.03	-40.54%	1,476.42	-6.38%
RUSSELL 2000	766.03	499.45	-34.80%	443.53	-11.20%

The next table shows the ten sectors of the economy, and what they have done from the November 20, 2008 bottom. This is very interesting data, because it shows how leadership within the economy and stock market are shifting towards the higher-growth sectors, and away from the defensive sectors.

SECTOR	11/20/2008	12/31/2008	SECTOR PERFORMANCE FROM NOVEMBER 20, 2008 LOW TO PRESENT
S&P 500	747	903.25	20.92%
Consumer Discretionary	128.83	169.41	31.50%
Consumer Staples	225.24	246.66	9.51%
Energy	324.54	386.35	19.05%
Financials	125.13	168.79	34.89%
Healthcare	262.38	309.41	17.92%
Industrials	171.6	207.21	20.75%
Information Technology	198.51	231.81	16.77%
Materials	112.06	137.59	22.78%
Telecommunications	91.26	111.7	22.40%
Utilities	133.16	147.93	11.09%

There are many old adages about investing, such as don't fight the tape, and the market is always right, the trend is your friend, etc. What the market is telling us, based on this sector analysis, is that the economy is going to enter a recovery period within a few quarters. If the market was expecting the recession to last for several years, the defensive names would continue to draw investors, and would thereby outperform the other sectors. This is not the case. Investors are putting their money into high-growth sectors, with the expectation that the economy will recover, starting probably in the second quarter of 2009. This is my expectation as well.

FIXED INCOME

The performance of fixed income securities has been mixed this year, with treasuries outperforming every other asset class, but corporate bonds and tax-frees performing poorly. The combination of frozen credit markets, making it impossible for corporations to issue debt this past summer, coupled with the near bankruptcy of the municipal bond insurers, had a devastating impact on the prices of these securities. Spreads for corporates, even those of high-quality companies, and for tax-frees, are at historical highs, providing opportunities for the astute fixed income investor. One must understand the risks and do their homework, but opportunities do exist for substantial yields and capital gains in the investment grade corporate and tax-free markets. I am still recommending that my clients keep maturities at five years and shorter, as rates in general are at historic lows, and I believe that they will rise over the coming few years, potentially erasing capital gains provided by the current spreads offered today.

REAL ESTATE

Home prices have fallen by an average of approximately 20% nationwide and by 41.5 percent in California. In Santa Barbara County, the median price has fallen from \$392,500 in December of 2007, to \$270,500, a 31% decline. However, in the city of Santa Barbara, price actually increased, from \$835,000 in December of 2007, to \$952,500 in December of 2008, or by 14%. I expect a further decline of approximately ten to fifteen percent, nationally, but feel we are past the worst of the negative impact of the excesses that led us to our current economic troubles. It's hard to say locally if we will continue to rise in price, or if foreclosures and the continuing deterioration of the economy will lead to lower prices.

Inventories have come down as well in California, falling from a 13.4 month supply, to just 5.6 months. Falling prices have really helped clear inventories, although foreclosures statewide will likely push inventories higher in 2009. I estimate that it will take at least another year before inventories and prices fall enough to form a bottom in the real estate market. Even so, I do not expect prices to rebound quickly, and would not expect to see prices return to the recent highs we have seen for many years, and not ever in some markets. The bottom line here is, for those who want to buy a home as opposed to speculate on a house, the next few years will offer opportunities. As an investment vehicle, however, I do not expect real estate to offer attractive returns for the foreseeable future.

COMMODITIES

I have never considered commodities to be an investment vehicle, although there are some managed futures funds that have achieved outstanding results. Given the weakness in the economy, and the sizable drops we have seen in commodities prices, especially in energy, I believe there will be potential for profits in commodities as the economy starts to recover in mid-2009. I prefer to focus on the companies that sell commodities rather than directly investing in commodities contracts. The energy sector has been pummeled, and energy stocks look attractive. I believe gold is significantly overvalued and will likely fall as investors once again seek-out risk and exit the flight to safety trade.

Keep in mind that stocks anticipate recoveries in the economy, normally by at least six months. If I am correct, and the economy begins to recover in the second quarter, stocks

should begin to rally very shortly (if they haven't already). I believe we will look back at the fourth quarter of 2008 as one of the worst markets in history, and also as one of the greatest opportunities to buy quality stocks at screaming bargains.

ASSET ALLOCATION

The following asset allocations are general guidelines intended as starting points. Each client must work with their advisors to identify the specific asset allocation that fits their unique investment needs.

Asset allocation accounts for up to ninety percent of total portfolio returns over time, so these initial asset allocation decisions are far more important than the individual securities themselves. However, investors should certainly do their homework, or work with a professional, to make the individual security selections for their portfolios as well.

INVESTMENT OBJECTIVE	STOCKS								BONDS						CASH	OVERALL ALLOCATION
	LRG GR	LRG VAL	MD GR	MD VAL	SM GR	SM VAL	INTL	TOTAL	TAX-FREES	TREASURIES	INV GRADE CORP.	HIGH-YIELD CORP.	AGENCIES	TOTAL		
INCOME ONLY (TAXABLE)	0%	0%	0%	0%	0%	0%	0%	0%	70%	0%	15%	0%	5%	95%	5%	0/95/5
BALANCED - INCOME BIASED	40%	0%	10%	0%	0%	0%	0%	50%	30%	0%	10%	0%	5%	45%	5%	50/45/5
BALANCED - GROWTH BIASED	55%	0%	10%	0%	0%	0%	5%	70%	10%	0%	10%	0%	5%	25%	5%	70/25/5
GROWTH AGGRESSIVE GROWTH	65%	0%	10%	0%	5%	0%	5%	85%	0%	0%	5%	0%	5%	10%	5%	85/10/5
	70%	0%	10%	0%	10%	0%	5%	95%	0%	0%	0%	0%	0%	0%	5%	95/0/5

For fixed income allocations, I recommend keeping all maturities to five years or shorter, as I believe rates will begin to rise, and will continue to rise for the foreseeable future. Rates are historically extremely low, and with the expansion of the money supply, and the potential for inflation, it is highly likely that the Fed will be forced to start raising rates within the year. Also, as the economy expands, demand for money will push rates higher as well. By keeping maturities relatively short, investors will leave themselves more options. As bonds mature, and if rates rise, investors will then be able to reinvest proceeds at increasing rates over time, increasing current income generated by their portfolios.

SECTOR	END 3Q07	1/30/2009	DIFFERENCE	REC WEIGHT
INDUSTRIALS	11.44%	10.64%	-0.80%	15%
CONSUMER DISCRETIONARY	9.41%	8.25%	-1.16%	12%
CONSUMER STAPLES	9.33%	12.98%	3.65%	3%
MATERIALS	3.22%	3.07%	-0.15%	5%
TECHNOLOGY	16.07%	16.33%	0.26%	25%
HEALTHCARE	11.65%	15.77%	4.12%	5%
TELECOMM	3.69%	3.68%	-0.01%	5%
FINANCIALS	20.29%	10.70%	-9.59%	20%
ENERGY	11.43%	13.96%	2.53%	8%
UTILITIES	3.47%	4.62%	1.15%	2%



As you can see in the table above, I am recommending overweighting those sectors that contain the companies with the highest growth potential, and am significantly underweighting those sectors with the more defensive, lower growth companies. This is because growth-oriented companies tend to outperform when the economy moves from a recession into a recovery, and since I believe we will enter a recovery phase in the second half of 2009, I feel this is the sector allocation that will benefit investors most, providing the best opportunity to outperform the overall market and achieve strong returns over the coming few years.

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February 5, 2009

