



PERSPECTIVES

JANUARY 2009

NUMBER 42

Year 2008

Talk With Us

A horrible year; there just isn't another way to say it. The U.S. financial system all but collapsed and only avoided total disaster by massive intervention from our Federal Government. Disaster here quickly moved around the world causing mayhem. Financial institutions from Europe to Australia came under pressure and some needed to be rescued by their local government. What started as a financial sector problem quickly affected general economies everywhere.

Until the Lehman Brothers collapse in September, financial sector problems mostly were being contained. However after the Lehman failure, investors lost confidence in all manner of financial instruments. As a result, markets froze. Without credit the economy can't function. The Federal Reserve and U.S. Treasury simply had to come to the rescue.

These events signaled the end of an era. The days of easy credit, excess leverage, and consumerism are over. It is not entirely clear what is coming, but a few things can be predicted: Both consumers and business will deleverage; restraint not excess will become important, and production not consumption will gain emphasis. (For specifics, see the **Forecast** section.)

Stock markets around the world took dives. Volatility went through the roof and investors everywhere wondered what hit them. The fall months were the worst, but

by December, things began to stabilize. The bond market was something else again.

Investors fled all manner of instruments for the safety of Treasury securities. As a result, yields for these instruments went to record lows. For other bonds, including investment grade corporate instruments, prices dropped as investors shunned these and yields climbed. Any risk was out, safety was an absolute requirement. The spread of interest rates between investment grade corporate and Treasury bonds reached record levels.

Both stock and bond markets reflected an historic level of fear and concern among investors all over the world. Another important factor, forced liquidation, drove markets during this period. Leveraged investment strategies, employed especially by hedge funds, became a problem. As trends went against them, some managers were forced to liquidate to cover debt margin requirements. This in turn created more fear, thus more selling, and then more forced margin debt selling, and so forth. Prices had to go to an extreme before bargain buying helped stabilize things.

The net result is that market returns this year are horrible. (See the **Major Indices** section of this report.) In fact, they are bad all over the world. All equity sectors suffered; there was simply no safe haven. What has happened happened. Now what?

A free market system cannot operate without functioning capital markets. Capital markets provide credit and liquidity for both buyers and sellers. It is the institutional medium for facilitating all manner of transactions. Inherent in capital markets is a degree of trust among participants.

Depositors in financial institutions need to be confident that their assets are safe and available for future use. Credit extended has the implied promise of return of principal as well as payment for its use. In some cases large financial transactions occur simply by word of mouth such as in stock trading. Without a reasonable level of honor by all participants, the system simply breaks down.

When a scandal like the Madoff fraud emerges, then trust is damaged. It is a black eye to all in the industry and calls into question all manner of relationships. What went wrong? Part of the answer is regulatory. The SEC certainly fell down on the job on this one. There were warning signs and even some in the industry with suspicions asked for an investigation. What little review occurred was inadequate.

However, even more than that, there has been a too loose regulatory structure. It is Riverplace Capital's belief that no investment company should be its own custodian. If Madoff's clients' assets were placed with a third party custodian, the fraud would have been almost impossible to perpetuate. RCM does not act as its own custodian and this ought to be an industry requirement. *(continued)*



MAJOR INDICES AS OF 12/31/2008

Large Cap Stocks (S&P 500)	-38.49
Dow Jones Industrial Average	-33.84
Mid Cap Stocks (S&P 400)	-37.28
NASDAQ Composite	-40.54
Small Cap Stocks (Russell 2000)	-34.80
MSCI EAFE	-45.09
Lehman Corp. Bond Index	5.44
Inflation	1.60

(EQUITY INDICES ARE TWELVE-MONTH RETURNS EXCLUDING DIVIDENDS)

Forecast

Economy

Sometimes turmoil in financial markets barely affects the economy at large. That is not the case this time. The credit crisis directly affected all business. Faced with liquidity concerns, companies started reducing costs and borrowing needs quickly. Employee counts were reduced with daily announcements of lay-offs. This produced a trend with predictable responses.

One was that the consumer pulled back fearing for his job and then companies fearing for their sales reduced costs further and so forth. The net result is a recession.

Now that a recession has taken hold, it will take time to reverse the trends that brought it about. More than that, major shifts are taking place. Short-term trends can be reversed by government policy responses.

(continued)



Forecast *(continued)*

That is taking place all over the world. So far the U.S. Government has, by either direct infusion or guarantee of obligations, given approximately \$8 1/2 trillion of support to the private sector.

Major trends, such as deleveraging by both consumers and business, may impact the economy for years. These long-term trends affect where we find opportunities and indicate sectors to avoid. One example would be retailing. In general, the consumer needs to retrench, pay down debt and be more selective. This sector is overbuilt and will need to downsize. Even though there might be some rebound by the consumer, retailing is a contracting sector. There also is overcapacity in the financial sector and a great deal of consolidation will continue among financial institutions. In both these sectors the strong may get stronger and many others will wither.

Expanding sectors would include green technologies, infrastructure building and repair, as well as the need for more and more technology solutions.

Equities

Technically, the stock market probably made a low in October, and then retested it in November. We are now in the early stages of recovery. That recovery can be agonizingly slow or quite rapid. We just don't know yet, but there will be a recovery.

The stock market generally anticipates turns in the economy by 4-6 months. The recession is already over a year in duration, so even if it lasts another year, the stock market may anticipate recovery as soon as this spring. No one knows how long the recession will ultimately last, but a stock market rebound may not be too far off. After all a 2-year recession is much longer than the typical 6 – 16 months.

Fixed Income

Treasury interest rates are too low and rates on many other instruments are too high. It is likely that they converge during 2009. Treasury bond interest rates will increase as investors regain confidence and begin to move money to other investments. At the same time corporate yields should come down because there will be more confidence in the credit worthiness of companies backing these bonds.

Talk With Us cont'd

We will request in forthcoming legislation, that this be included.

There are other issues that are pertinent and RCM as part of an important industry will push for additional safeguards. No amount of regulation can eliminate all fraud and misbehavior, but a Ponzi scheme like the Madoff scandal can be made nearly impossible to pull-off.

Without an investment industry and viable financial institutions, America and our free market system will not work. We simply have to do whatever it takes to restore confidence. At a time when the entire financial industry is in crisis, reviewing all practices is appropriate and even necessary. At Riverplace Capital we work for our clients' interests and provide the best and most appropriate advice and investment management we know how. We cannot avoid every downturn, but you can count on us not to be drawn into fads and flaky investment opportunities. We would like to discuss your situation,

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Investment Strategy

Equities

As always, we constantly review all stock holdings regularly. We want to assure ourselves that the reasons we invested in the companies that the stocks represent are still valid. After the terrible markets of the past year, the inclination is to find the safest sectors or not invest at all. Both are mistakes.

Some safe sectors, like healthcare, have always made sense because they offer a long-term growth opportunity. Some others are so highly priced because so many other investors are doing the same and therefore there is more risk in them than opportunity.

What we are doing is maintaining a balanced approach with plenty of exposure to the safe growth areas, but also some exposure to those sectors that are beaten down and have tremendous appreciation opportunity when the economy begins to improve. There is simply no other good way to recover from a down period like the recent one. Opportunities abound, stocks are really cheap, we simply have to separate the wheat from the chaff. (Remember, the lower stocks go, the less the subsequent risk. It is simply a matter of value.)

Fixed Income

Recently, we have been finding terrific yields in corporate and municipal bonds. For this reason we have been aggressively purchasing these for our clients. In fact, we are even willing to modestly overweight some balanced accounts, where appropriate, in bonds. This is because the returns here are competitive with the long-term historic average returns for equities with less risk.

Credit analysis is important in selecting bonds and not everything can be assured, but the risk-reward is very much in favor of the investor today. We are, however, keeping the maturity range short to intermediate. Although currently inflation is not a problem, longer-term the actions our Government is taking in monetary and fiscal policy make inflation a real risk.

Asset Management

Because interest rates for corporate and municipal bonds are so attractive, we have mostly upped the allocation to these sectors and reduced ones to treasury securities. We are also reducing allocation to the mature international economy sector and increasing the emerging market weighting. In short, RCM is moving assets to where the opportunities are greatest.

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